Private Debt Investor

Perspectives 2020

February 2020 • privatedebtinvestor.com

EXPERT TALK

4 questions to Laurent Bénard, Managing Partner of CAPZA

Q Who is CAPZA?

CAPZA[1] is an established European private investment platform focused on small and mid-cap companies. Since 2004, we have been providing them with flexible financing solutions throughout the capital structure. Our unique platform of 4 complementary strategies - Flex Equity, Private Debt (Unitranche, Mezzanine), Transition[1] and Artemid Senior Loans[1] - enables us to support companies over the long term at different stages of their growth journey.

Q What is the sweet spot for private debt investment today ?

We provide unitranche / mezzanine financing to companies between €10 million to €40 million of EBITDA across continental Europe. We believe this is a sweet spot that the mega funds have abandoned for larger deals and that is full of value creation potential.

Q Do you consider capital deployment to be a challenge, considering the fierce competition on the European direct lending market?

In a market where a lot of money is chasing a limited number of opportunities, we have demonstrated our ability to deploy capital into more than 90 transactions over the past 15 years. We have already completed 7 investments with our fifth private debt fund launched in July 2019. This has been possible thanks to our unique sourcing capabilities: our existing portfolios of equity and private debt have proven to be a fertile ground of opportunities as illustrated by the high level (64%) of proprietary / repeat transactions completed.

Q In the current environment, what kind of transactions are you looking at?

Deployment should not come at the cost of quality. We continue to focus on resilient industries such as healthcare or IT and Software, that represent more than 50% of our investments. Our long lasting experience across credit cycle has enabled us to build a robust process with emphasis on credit quality and no compromise on documentation. This consistency of approach resulted in a particularly low loss rate since 2004.

CAPZA

European independent private investment house providing tailor made financings to small and mid-cap companies at every stage of their development

Since
2004

50+
People[3]

€3Bn
Assets managed or advised[2]

190+
Transactions since creation[3]

www.capza.co

(2) As of December 2019, of which assets managed by a third party and advised by Artemid SAS; (3) As of December 2019 including Artemid and Transition.

(1) CAPZA is the commercial name of Atalante SAS, portfolio management company approved on 11/29/2014 by the « Autorité des Marchés Financiers » under the number GP-04000065. The funds of the CAPZA Transition range are managed by CAPZA, and advised by CAPZA Transition SAS which has financial investment advisor status (CIF in France) and is registered under the Orias under the number 18001601 since the 23/03/2018. The funds of the Artemid range are managed by CAPZA and advised by Artemid SAS, which is a subsidiary of CAPZA and Amiral Gestion and has financial investment advisor status (CIF in France). Artemid SAS is registered by the Orias under the number 14003497 since the 05/28/2014.

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Perspectives 2020

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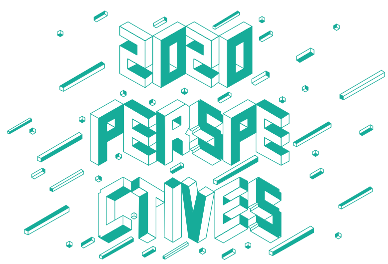
LP Perspectives Survey 2020 gives valuable insights into allocations and strategies for the year ahead



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Insight

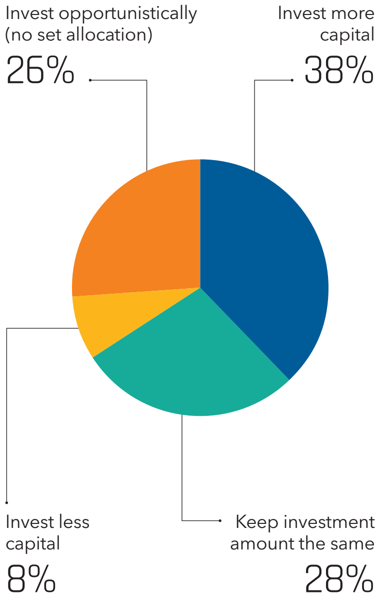
Seven LP perspectives that matter **With investors lining up to put more money into private debt, our LP Perspectives Survey 2020 gives valuable insights into allocations and strategies for the year ahead**

Europe's appetite for private debt is at an all-time high, with an expanded array of investors attracted to the asset class. Managers are under pressure less to find backers and more to source suitable debt to fund or acquire. According to the *PDI LP Perspectives Survey 2020*, more than a third of the 146 participating institutional investors globally felt they were underallocated to private debt, a figure that is higher than for any other alternative asset class.

In light of these findings, understanding the thinking of the LP community is vital, as the strong market drives a growing level of sophistication among investors. Many are looking to expand the number of debt managers they have relationships with and are broadening their horizons into new markets and strategies in order to build allocations.

The following charts highlight the seven big themes that are front of mind for private debt's institutional investors.

How much capital do you plan to invest in private debt in the next 12 months compared with the previous 12 months?

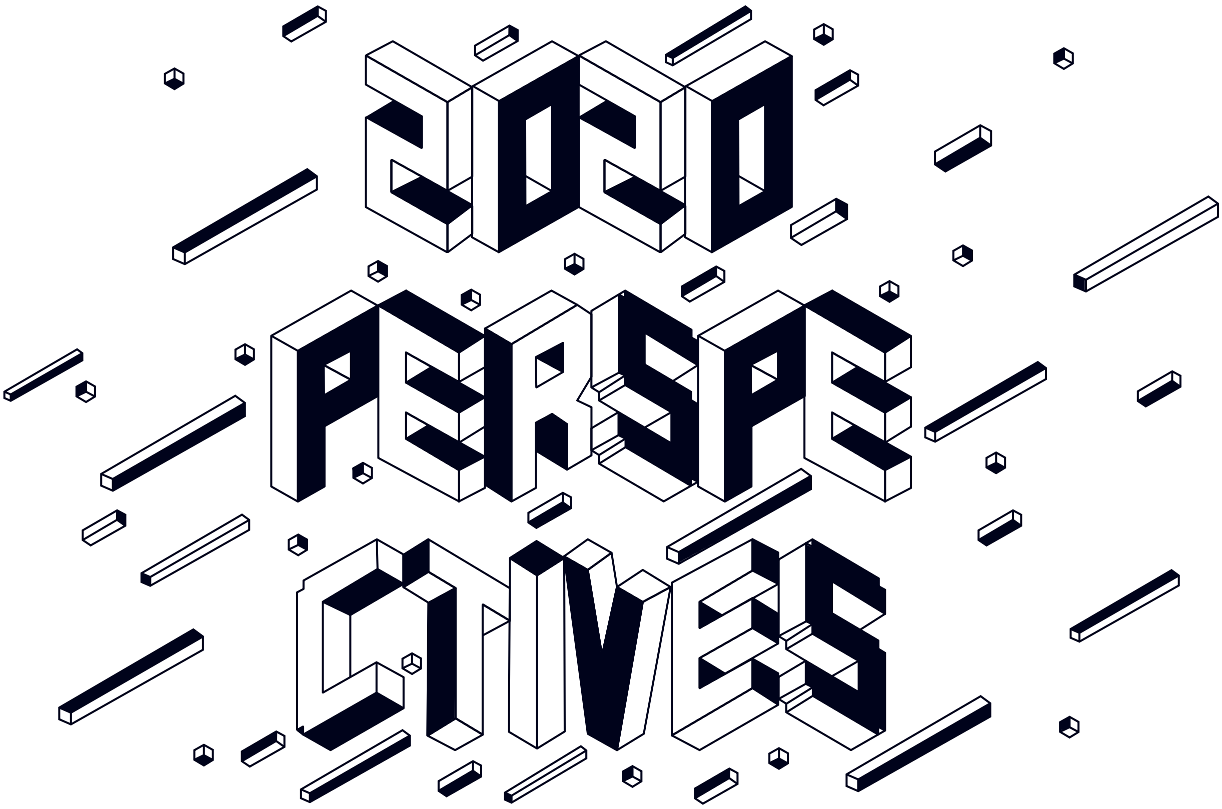


DEMAND FOR PRIVATE DEBT

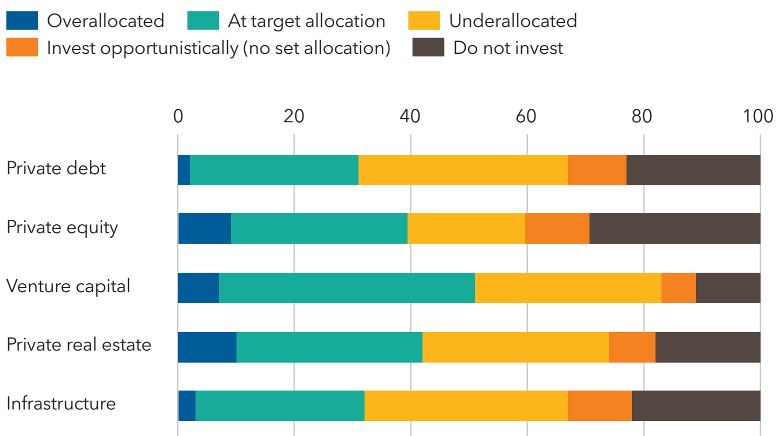
The majority of institutional investors plan to invest more in private debt in 2020 than they did last year. Some 38 percent are planning to increase their allocation in comparison with just 8 percent who expect to put less capital to work in debt.

Even as investors become increasingly sophisticated in their understanding of the private debt opportunity, more than 26 percent are investing opportunistically in the asset class without a fixed allocation in mind.

Only 28 percent of investors plan to keep their investment amount the same in 2020, a significantly lower figure than seen in other alternative asset classes. The majority of LPs in private equity, venture capital and private real estate intend to keep their allocations stable for the year ahead.



What is your current allocation position for the following asset classes? (%)



UNDERALLOCATED TO THE ASSET CLASS

More than a third of institutional investors describe their current allocation position to private debt as underallocated, at 36 percent – higher than the corresponding figure for any of the other alternative asset classes. Only 2 percent consider themselves to be overallocated, much lower than the 7 percent who say they are overallocated to private equity and the 10 percent who say their current allocation to private real estate is higher than they would like it to be.

38%

of institutional investors will increase private debt allocations

29%

of respondents will commit more capital to direct lending

69%

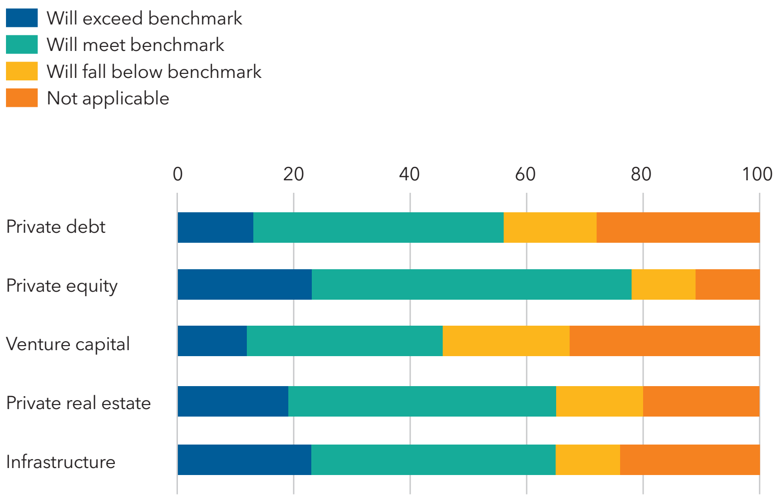
of LPs want to put more money to work in asset-based lending

FAILING TO MEET BENCHMARKS

Coller Capital's *Global Private Equity Barometer* recently showed that LPs are expecting lower returns. *PDI*'s own survey of investor sentiment finds that private debt was one of the two alternative asset classes considered least likely to perform ahead of benchmark in the coming year, along with venture capital. Only 20 percent of LPs say their private debt portfolio outperformed in 2019 and only 13 percent expected it to do so going forward. This is partly the nature of private debt, which has limited potential for upside, though losses can be significant in the worst downside scenarios.

In Coller's poll, 75 percent of LPs said an increase in the number of credit managers would lead to lower returns, although respondents pointed to covenant-lite deal sources as a reason for lower recoveries in the year ahead.

How will the following asset classes perform against their benchmarks in the next 12 months? (%)

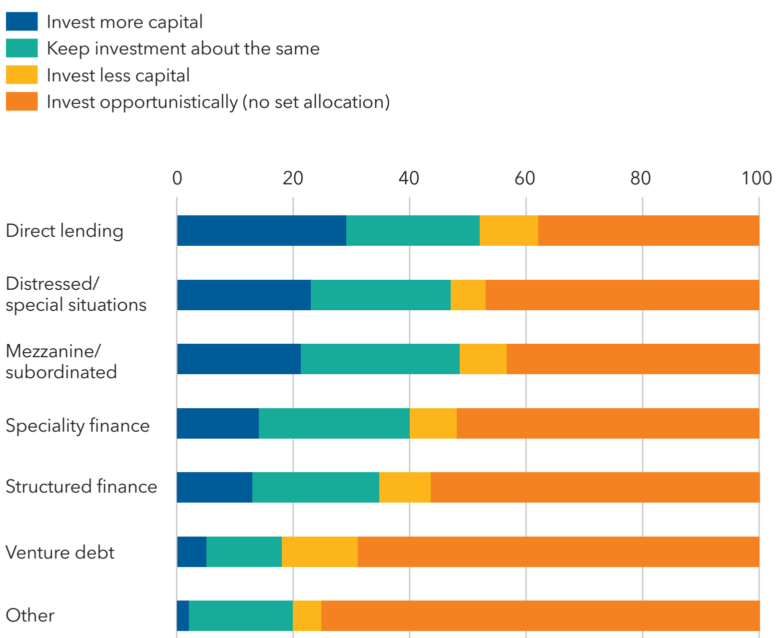


DIRECT LENDING STILL GROWING

Direct lending remains the most popular strategy for additional investment, with 29 percent of investors saying they would like to commit more capital to the strategy in 2020 than they did in the previous 12 months. This was followed by distressed and special situations at 23 percent and mezzanine or subordinated debt at 21 percent. One in 10 planned to reduce their allocation to direct lending.

Despite the attractiveness of the technology sector for many investors, venture debt was considered the least attractive strategy, with 13 percent expecting to invest less in that strategy and only five percent planning to increase their exposure.

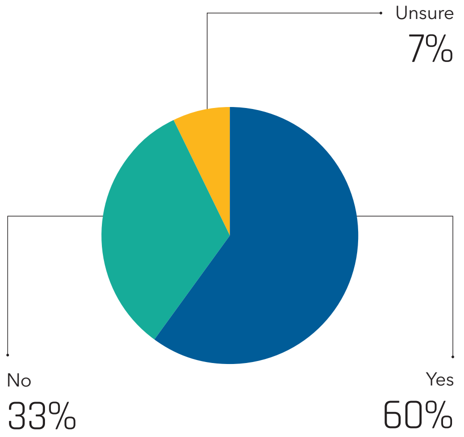
How much capital do you plan to invest in the following strategies in the next 12 months compared with the previous 12 months? (%)



CALLS FOR GREATER FEE TRANSPARENCY

As investors get increasingly sophisticated, they are demanding much greater fee transparency and disclosure from their GPs in all alternative asset classes. In private debt, reporting is becoming much more detailed, granular and interrogative, with 60 percent of LPs saying they have asked for more fee transparency and disclosure from managers in the past 12 months. Despite this, only 13 percent say they were seeking external help when it comes to fee validation.

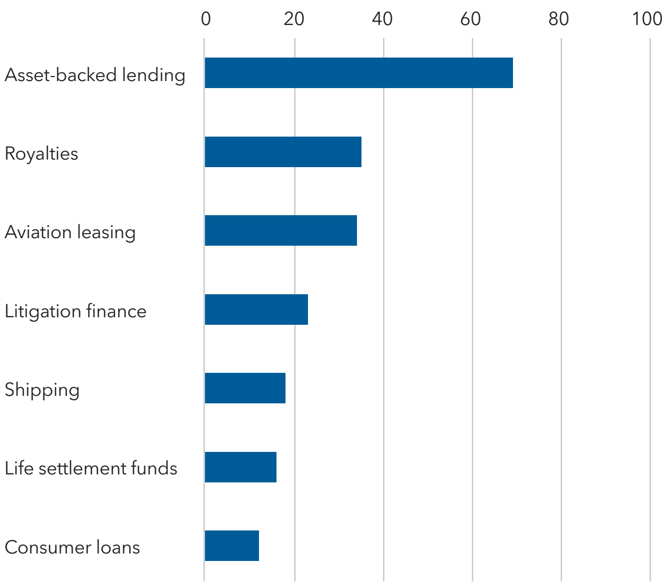
Have you asked for greater fee transparency and disclosure from your GPs in the past 12 months?



ASSET-BACKED LENDING IS GETTING INTERESTING

Of the emerging asset classes that are of interest to investors, debt was top of the pile, with speciality finance such as asset-backed lending set to attract growing commitments in 2020. In all, a massive 69 percent of LPs surveyed say they would like to put more money to work in asset-based lending strategies in 2020, with 35 percent interested in royalties and 34 percent in aviation leasing.

Which emerging asset classes do you plan on committing to over the next 12 months? (%)

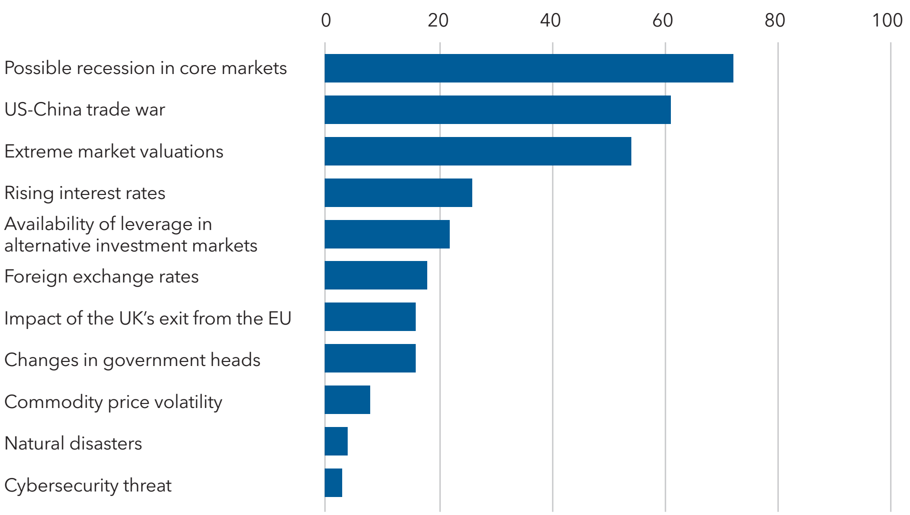


RECESSION IS A LOOMING CONCERN

Considering 2020, investors are fearful about a possible recession in core markets or an escalation of the ongoing US-China trade war as the most likely factors to have an impact on performance in their private markets portfolios.

The impact of the UK's exit from the EU was only of concern to 16 percent of survey respondents, while more than half were fearful of the potential impact of extreme market valuations.

The risk of a possible recession and the US-China trade war are the factors most likely to have the greatest impact on performance (%)



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Editor's letter

No need to lose the faith

Andy Thomson
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Down but far from out – that's the state of the private debt market in the early stages of 2020. 'Down' because our latest fundraising figures show a substantial fall in private debt fundraising globally to $147 billion in 2019. This compares with the $176 billion collected in 2018 and the all-time record of $253 billion gathered in 2017. 'Far from out' because numerous sources tell us the subdued fundraising market of the last couple of years was a natural response to the glut of capital raising in 2017. With some areas of the market, such as direct lending, having become fairly saturated, investors are pausing and taking stock. This does not mean they have lost faith in private debt.

This conclusion is lent credibility by the findings of our *LP Perspectives Survey 2020*. It shows that investors are keen to add more private debt to their portfolios. Just 2 percent of those surveyed say they are overallocated to the asset class, while the proportion who say they are underallocated (36 percent) is bigger than the number saying they are at their target allocation (29 percent). One can only assume there's plenty of capital raising to come if targets are to be met.

> **"Investors are pausing and taking stock. This does not mean they have lost faith in private debt"**

Nor is this any real surprise, as LPs seem by and large to be happy with the performance the asset class has provided. When asked how various asset classes have performed against benchmarks, 55 percent say private debt has either exceeded or met them. Only 11 percent say performance had fallen below the benchmark.

Furthermore, there is no sense that private debt performance is about to nosedive in the years ahead. More than half of the LPs canvassed say performance will meet or exceed the benchmark, with 16 percent anticipating underperformance.

Of course, none of this offers any reason for private debt GPs to become complacent. There are plenty of concerns around deal structures and, as the cover story in this month's main issue points out, the covenant-lite phenomenon could mask underlying problems with loans for long enough that it becomes too late to do much about them. Nonetheless, our survey does provide encouragement for managers perhaps worried that investors may flee for the hills: there is very little sign of that.

Andy Thomson

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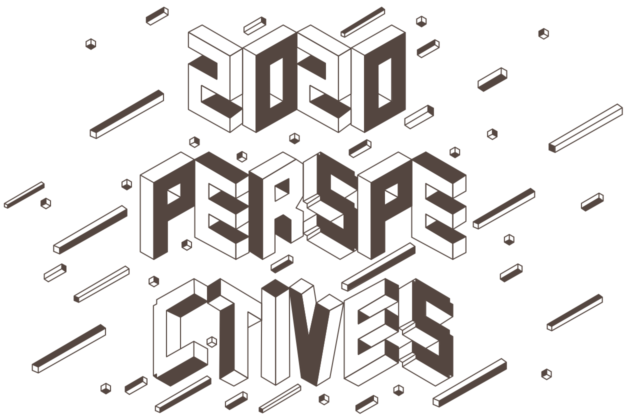


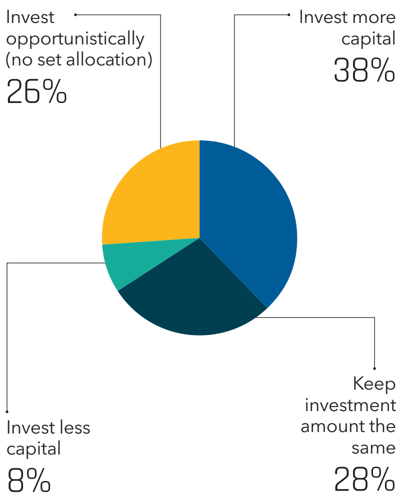
LPs can't get enough of private debt

As investors continue to wise up to the appeal of private debt, all indications are that allocations and commitments will continue to rise. By Claire Coe Smith

When we published the first-ever ranking of the world's largest institutional private debt investors back in November, some of the numbers were eye-popping. Our research and analysis of the top 30 global investors, based on the market value of their private debt portfolios, revealed a total capital commitment of $230 billion to private debt by those firms alone. The top 10 investors have committed $153 billion.

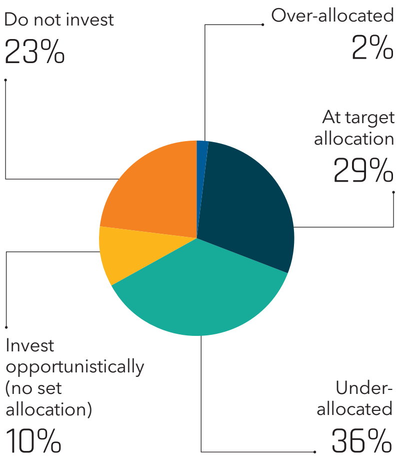
The *PDI LP Perspectives Survey 2020* shows that these figures may just be the tip of the iceberg, with investors eager to deploy additional capital to the asset class. More than two-thirds of the LPs surveyed plan to invest more in private debt in 2020 than they did last year. Only 8 percent are planning to reduce their commitments. Furthermore, 36 percent of LPs told us they currently consider their institutions to be underallocated to private debt – a figure that is higher than for any other alternative asset class. In fact, only 2 percent believe they are overallocated; compare that with the 7 percent that are overallocated to private equity, the 9 percent that are overallocated to venture capital, and the 10 percent that are overallocated to private real estate.

How much capital do you plan to invest in private debt in the next 12 months compared with the previous 12 months?

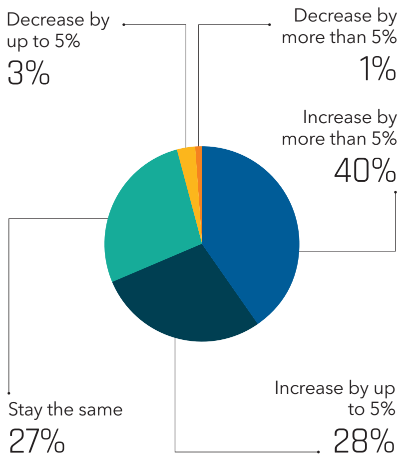


The breadth of investors that are committing to private debt strategies has grown markedly in the decade since the global financial crisis, with some of the biggest players committing nearly a fifth of their funds to the asset class. In November, we questioned whether private debt should still be considered alternative when the likes of Texas County and District Retirement System are

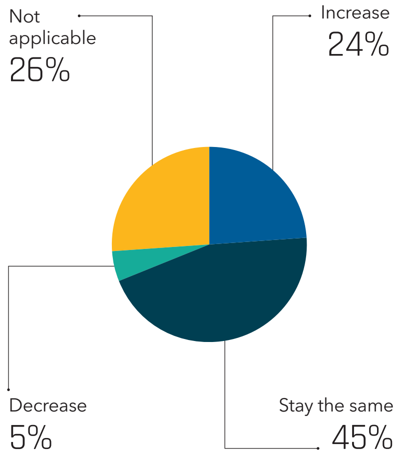
Please indicate your current allocation position for private debt:



How do you think the proportion of your total assets under management allocated to alternatives will change in five years' time?



How will your average commitment size to private debt funds change over the next 12 months?



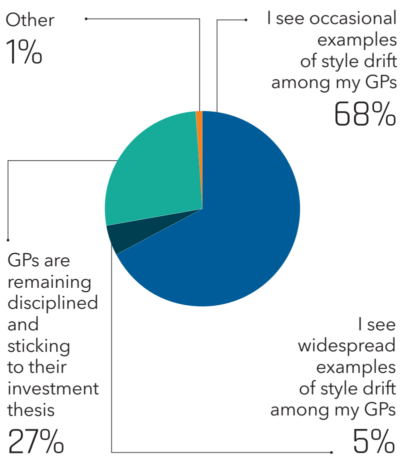
committing nearly 19 percent of their money to it. The Arizona State Retirement System currently allocates around 18 percent of its assets to private lending.

Our *LP Perspectives Survey 2020* suggests investors are bullish about increasing the proportion of their total assets under management allocated to alternatives over the next five years. In all, more than two thirds of LPs plan to increase their allocations to alternatives, with 40 percent intending to increase those allocations by more than 5 percent.

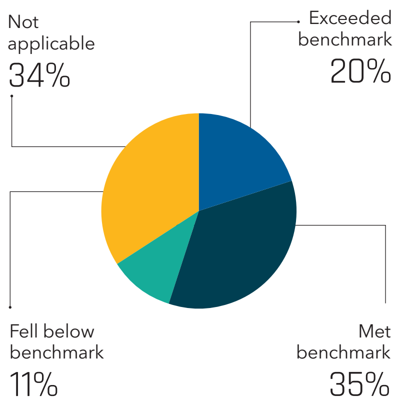
When it comes to private debt, the investor base is clearly growing and it is a key part of the returns strategy for these institutions, even though most LPs recognise that debt strategies are less likely than private equity to outperform their benchmarks. Only 20 percent of our respondents report their private debt assets having exceeded benchmark levels in 2019 and, when making predictions about the year ahead, only 13 percent are anticipating private debt investments to perform better than their benchmarks. With 16 percent expecting private debt assets to fall below benchmark levels in 2020, the asset class is behind only venture capital in terms of investor confidence in the performance of the assets.

Within private debt, investors plan to shift more capital towards direct lending and distressed and special situations in 2020. Nearly three in 10 plan to increase their commitments to direct lending, and distressed/special situations and mezzanine/subordinated loans are set to receive greater investment from more than 20 percent of

Which of the following best describes your assessment of GP investment behaviour in the past 12 months?

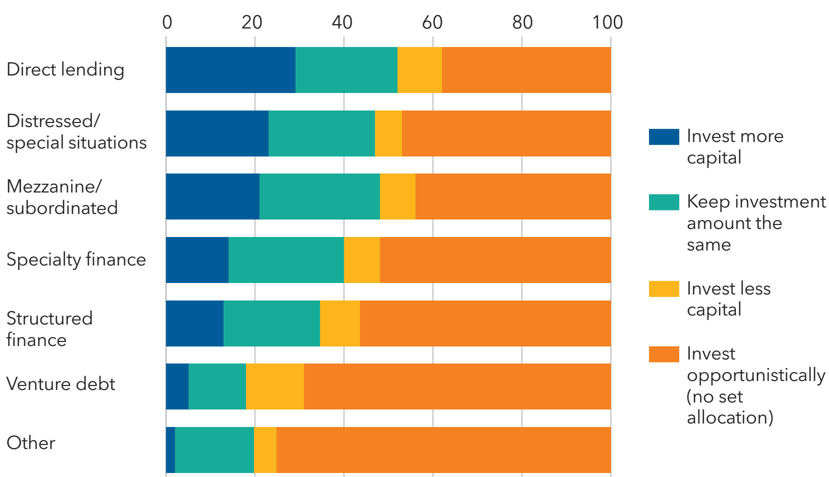


How has private debt performed against its benchmark over the past 12 months?



Figures may not add up to 100% due to rounding

Regarding private debt, how much capital do you plan to invest in the following strategies in the next 12 months compared with the previous 12 months? (%)

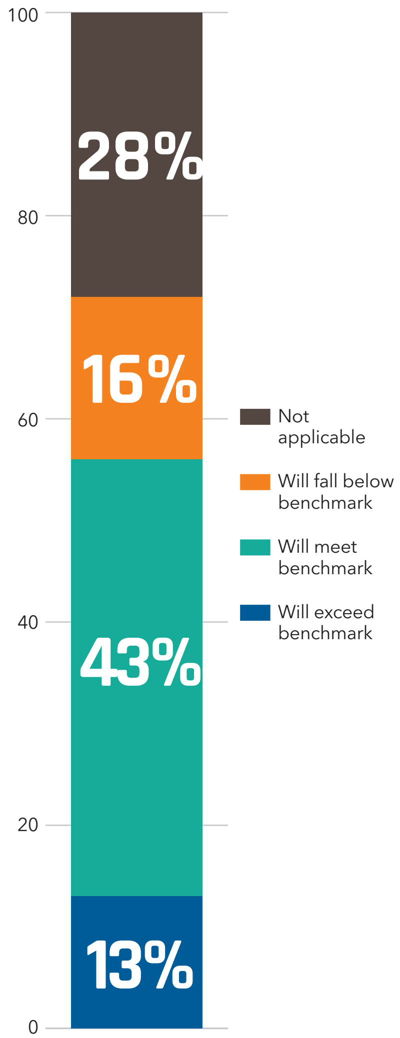


respondents. Speciality finance is earmarked for expansion by 14 percent of respondents, with venture debt more likely to see a downsizing, as 13 percent plan to reduce their allocations.

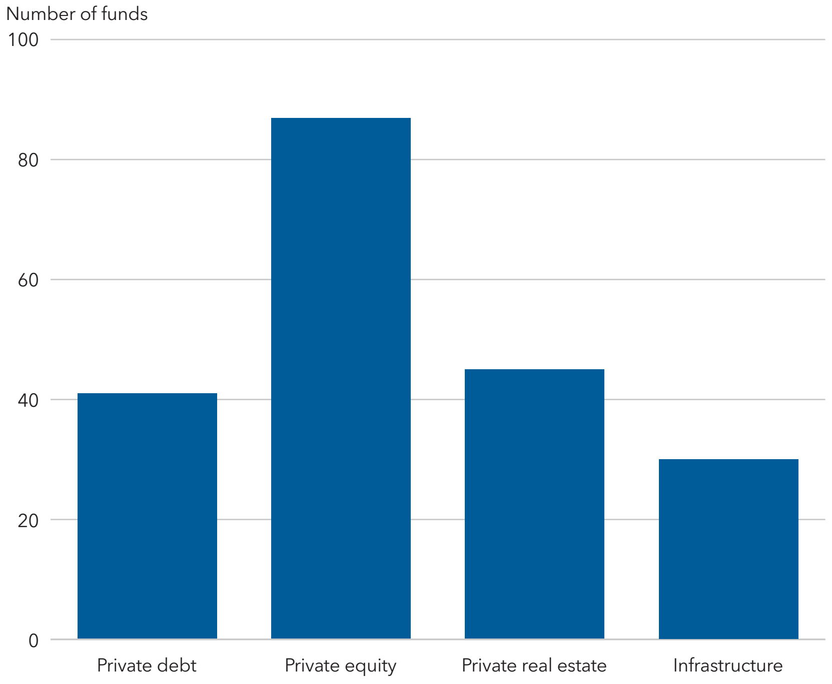
Broadening horizons

A quarter of private debt investors expect their average commitment size to increase over the next 12 months, with 45 percent expecting it to stay the same and only 5 percent planning to scale back. With the average investor now being presented with 41 fund opportunities a year in private debt – compared with 87 in private equity and 30 in infrastructure – many are looking to expand the number of debt managers they have relationships with. Many investors are

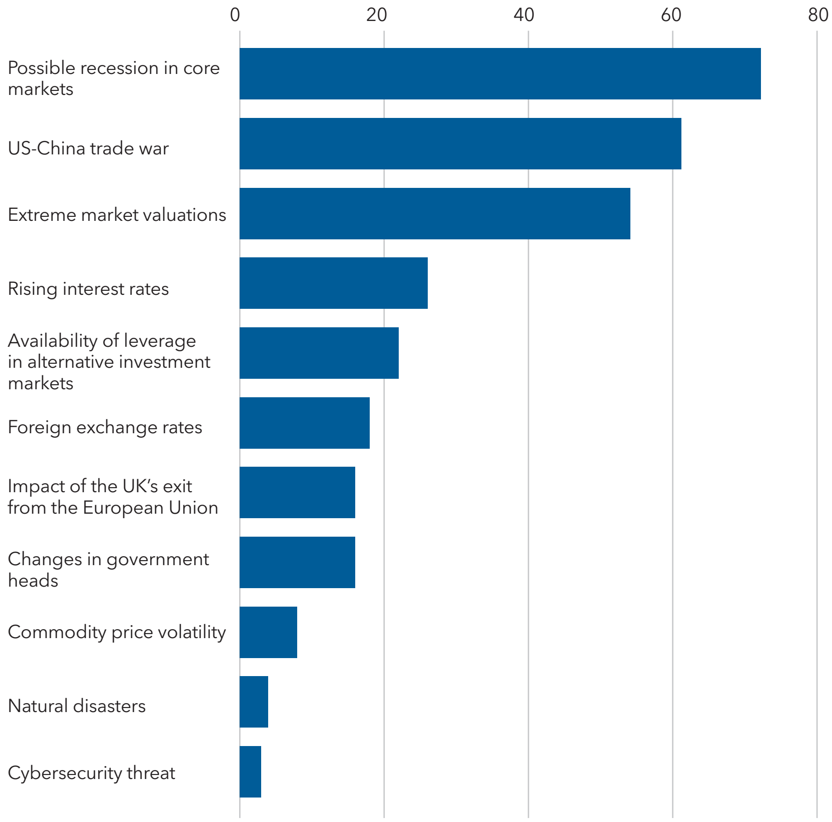
How do you feel private debt will perform against its benchmark in the next 12 months?



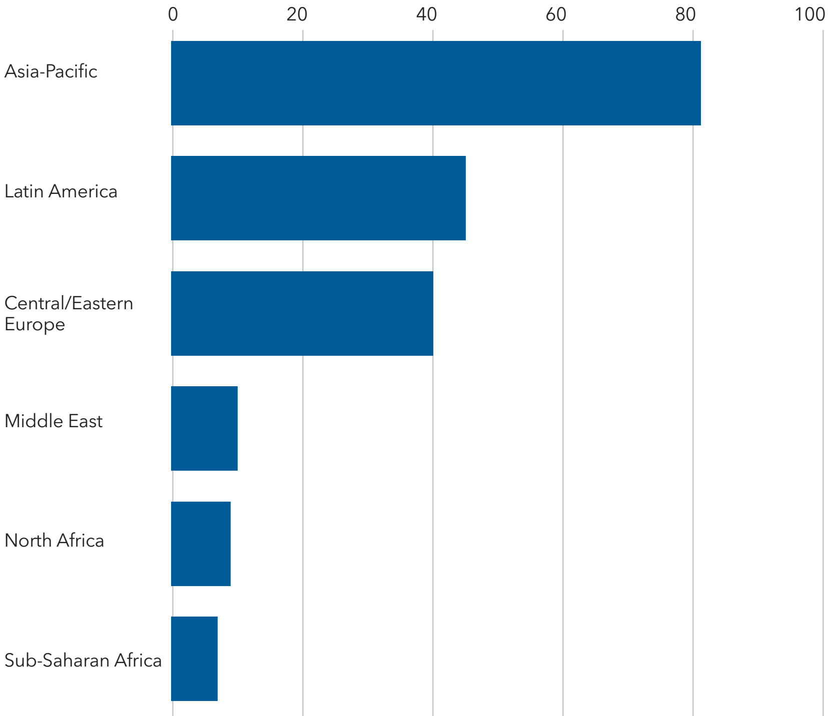
On average, how many fund opportunities are presented to you per year?



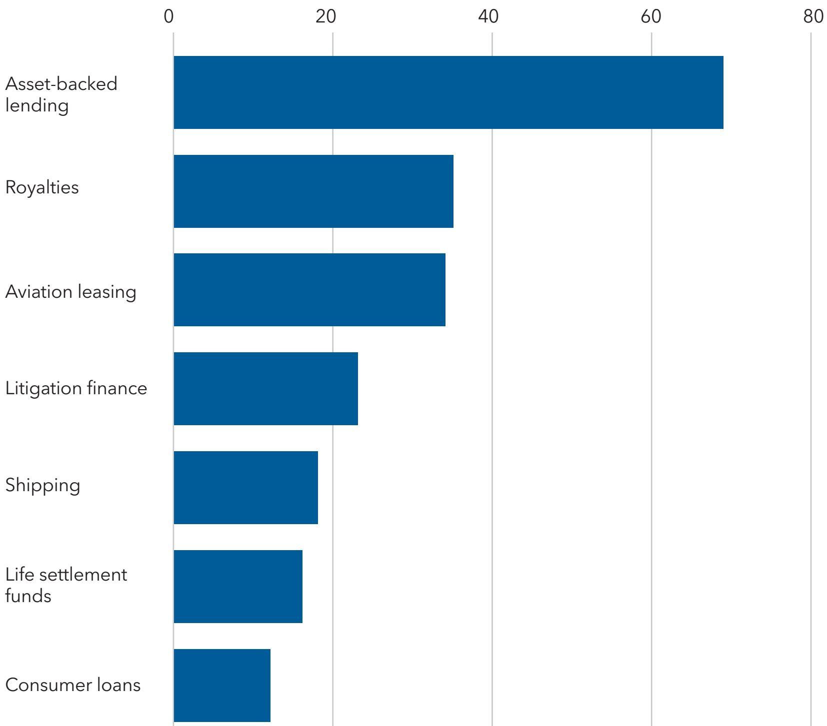
Thinking of your private markets portfolio, which three factors will have the greatest impact on performance over the next 12 months? (%)



Which of the following emerging market geographies will you consider for investment over the next 12 months? Multiple responses allowed (%)



Which of the following emerging asset classes do you plan on committing to over the next 12 months? Multiple responses allowed (%)



Source for all data: Private Debt Investor

also looking at a wider range of jurisdictions for opportunities to put their capital to work.

Demand to invest in European private debt is especially high, particularly when it comes to real estate private debt. There is also a growing appetite for emerging markets, with 40 percent of investors planning to consider central and eastern Europe in 2020. Greater activity from CEE-focused managers and debt funds was observed during the second half of 2019, with real estate assets in that region proving highly sought after.

Beyond Europe, Asia-Pacific is now a consideration for more than eight out of 10 investors, with Latin America on the agenda for 45 percent. Africa continues to be earmarked by far fewer LPs, with only 7 percent anticipating investing in Sub-Saharan Africa and just 9 percent looking at North Africa.

Preparing for a downturn

As we begin a new decade, it is clear that investors are anticipating a downturn that will have a significant impact on the performance of their private markets portfolios in the next year or so. We asked LPs about the factors they expect to have the greatest impact on performance in 2020. The risk of a possible recession in core markets is the principal concern, having been raised by nearly three in four respondents.

That sentiment is undoubtedly leading to increased demand for more opportunistic strategies that can benefit from dislocation in the market.

It is also resulting in lengthier due diligence processes and investors spending more time scrutinising GPs on their ability to manage assets in difficult market environments. A particular concern in the event of a downturn is that managers will deviate from their stated investment thesis in an effort to source deals; already, 68 percent of investors tell us they see occasional examples of 'style drift' among their GPs.

Beyond the risk of recession, LPs are also concerned about the impact of the US-China trade war on the performance of their portfolios, with more than half concerned about the impact of extreme market valuations. Allocations and commitments may be on the up, but investors are well aware of some of the potential bumps in the road facing private debt managers as the asset class continues to grow. ■

How we conducted our LP survey

The LP Perspectives Survey is Private Debt Investor's annual study of institutional investors' approach to alternative asset classes

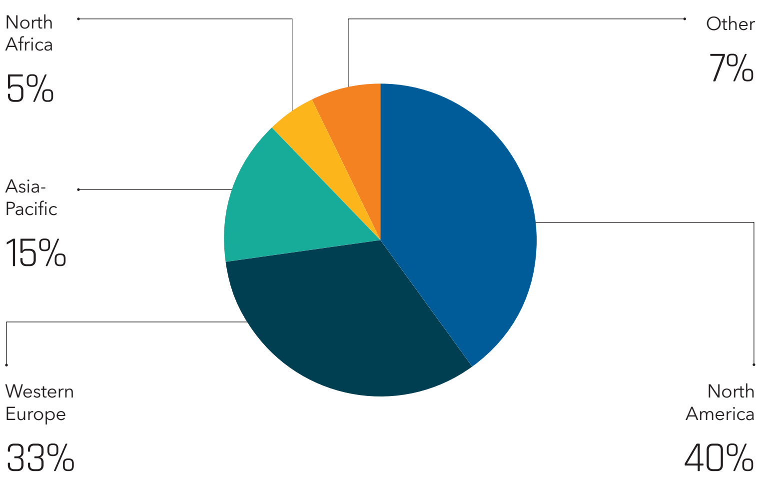
The *PDI LP Perspectives Survey 2020* aims to provide a granular view of the alternatives market, both current and future, by gathering insight on investors' asset allocation, propensity to invest and performance predictions.

It is a global study, reflected in the question set and the respondents, which allows for meaningful global views and cross-regional comparisons across alternative asset classes.

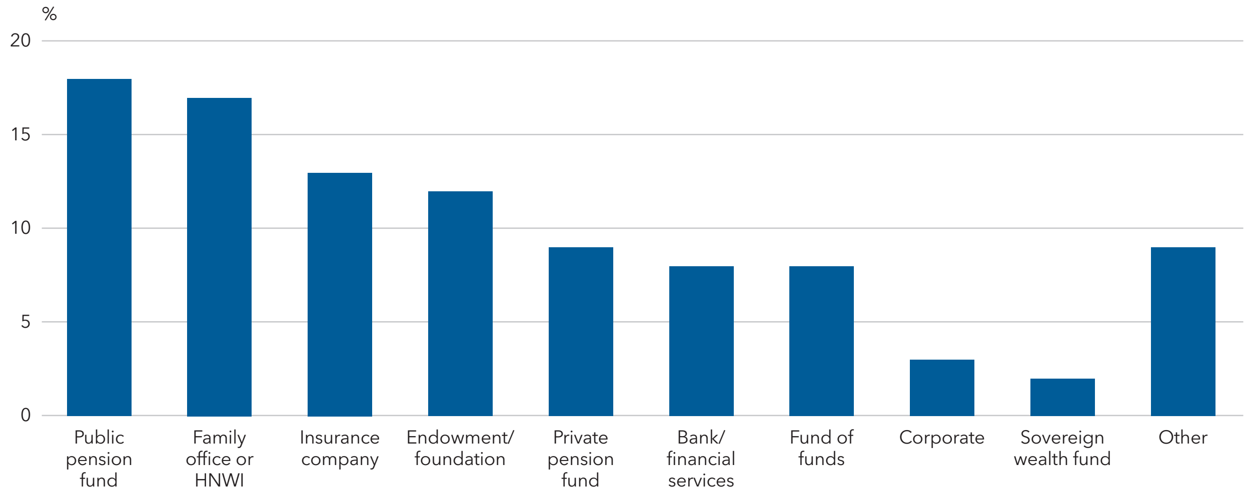
The survey questions are reviewed annually, with the objective of reflecting market developments and shifts in sentiment.

For this edition, *PDI*'s Research & Analytics team surveyed 146 institutional investors. Fieldwork was carried out from August to September 2019. Participation is anonymous, with the findings amalgamated and presented in this supplement.

In which region is your institution headquartered?



What type of institution are you?



Source for all data: Private Debt Investor

EXPERT Q&A

As private credit continues to thrive in Europe, Tavneet Bakshi, head of EMEA at FIRSTavenue, says fund terms are still evolving towards greater alignment of LP and GP interests

Investors want a shared vision

Q In the current market, what are the fund terms that matter most to investors?

We are not seeing any dramatic changes, but the increasing trend is a focus on stronger alignment through fund terms. That manifests itself in several ways, specifically in the private debt space, where the fund fee has probably been the area of most focus. A number of allocators and consultants are very keen on making sure they are paying for what they get, so there is ongoing push-back on fees on committed capital in favour of fees on invested capital. That trend has been around for a few years.

In the more esoteric, opportunistic strategies, fund managers have managed to keep their pricing power, but even there we see pressure on headline fees on committed capital. In Europe, a number of special situations managers are still able to maintain fees on committed capital, but they are also targeting higher returns and employ a more private equity-like approach to their investments.

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There is still scrutiny around the GP commitment – these days there are more questions on the level of that commitment and also what goes into that, who makes that up, where it comes from and whether it represents the right level of risk sharing. There is definitely a growing aversion to a GP commitment in kind, where forward fee income forms part of the GP commitment. The abiding theme really is around alignment when LPs are talking through these terms.

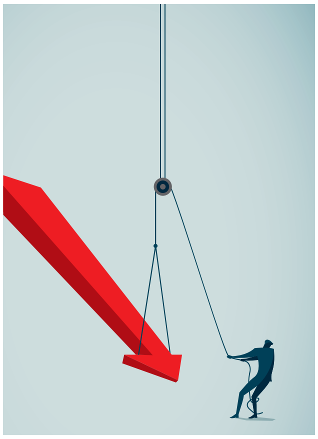
Use of leverage has continued to split opinion. There are two facets to this: short-term borrowing through the use of subscription facilities; and term debt that is longer in duration and greater in size. Subscription facilities have received a lot of attention over recent years, particularly where GPs were 'overusing' to delay drawing capital and boosting IRRs.

We tend to see more specific language in side letters specifying a cap or time limit to the use of such facilities and increasingly GPs are pro-actively stating caps in their legal documentation. Longer-term debt needs to be considered in the context of the underlying strategy and the overall risk profile of the investment. We regularly hear investors ask for levered options where the underlying investments have a senior and likely secured profile. However, there has been increased caution as to the terms of leverage applied, the recourse of that leverage and whether there is a significant mismatch between debt terms and investment duration.

Q What are the bones of contention when it comes to fee levels?

Q What are the current themes in the secondaries market? How are concerns over fund-led processes playing out?

For debt specifically, there really is quite a bifurcation in the secondaries market. There is a cohort of believers who think that private credit secondaries are only going one way in terms of levels of volume and attractiveness of opportunities, and that is up. Then there are also a number of very sophisticated investors and players in the market who think it's just too early to think about a meaningful private credit secondaries market.



We think it's an interesting space and we are already seeing opportunities in that market. At the moment, it tends to be more mixed in terms of whether flow derives from GPs restructuring or LPs reallocating their portfolios. There is no clear trend of one leading the other, but if you look at private equity, the LP-led secondary process has become quite plain vanilla. It's a brokerage market almost, whereas the GP-led secondaries opportunities require more structure and value-add.

There's no reason why the private credit market won't follow the same route, but it's just very early relative to private equity. One challenge is that in credit, typically there is a shorter hold to maturity – whereas private equity might have a 10-year hold over a position, debt investments could have an average of three to five years. That means when we think about effective secondary credit portfolios, diversification is a big factor. We are already starting to see flows and have been for some time, so we expect that to increase next year. Perhaps not a hockey-stick increase, but just incrementally more flow and more players entering the market.

Q How are investors protecting themselves in anticipation of a downturn?

There is a macro and a micro answer to that. At a macro level, it's picking your spot in terms of subsectors within private debt that you are going to be exposed to. That means we are definitely seeing an increased demand for more opportunistic strategies that can take advantage of dislocations in the market through a downturn yet also deliver interesting returns if we continue to have a benign or slow deterioration of the markets.

From a micro perspective, it is making sure you are not paying through the nose in the face of market conditions that don't allow your GPs to meet their projected returns.

That's the driver for so much more modelling on what the fee expense could look like in all scenarios – making sure the pricing is right so there's not a lot of bias benefit to the GP if things go wrong. Additionally, investors are keener to diligence a GP's capability to manage difficult market environments – what happens if things go wrong. We see more questions from LPs about how assets will be managed, how returns will be protected and how GPs will actually ensure that they are not losing money. This can be an advantage for GPs on a larger platform or with the ability to roll out teams to focus on restructuring and workout processes if required.

When it comes to investment-level fees – deal fees and origination fees – there remains a preference that income should offset management fee expense and that all investment-related revenue should go into the fund.

Back to the alignment point, LPs want to see changes where GPs are keeping some or all of that origination fee and only filtering through the investment return into the fund. This is probably more prevalent in the US than in Europe, where we tend to see GPs contribute all fees to the fund.

Investors continue to focus on hurdles/preferred returns and catch-ups. These days there just isn't a structured fee model that works for everyone and so LPs are spending the time to model out return scenarios to try and understand what happens and where the sensitivities lie if the GP is not necessarily achieving the target.

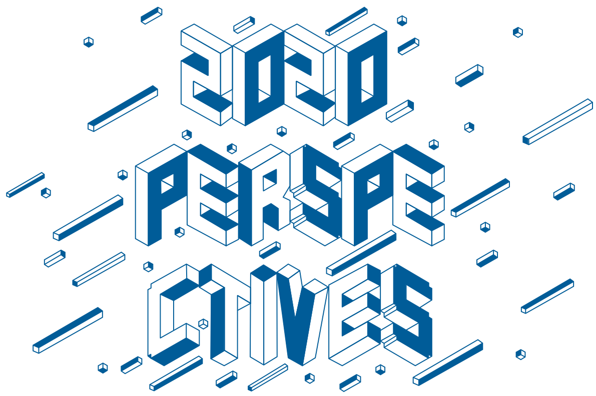
We are seeing this become standard practice in the due diligence and the fee negotiation process, particularly for the lower-returning debt strategies. More generally, there is downward pressure on the preferred return and a movement away from 100 percent catch-up for the GP.

"We are seeing more focus on asking for the accounts and asking GPs, particularly newer GPs, to share their budgets"

Q When it comes to due diligence, how closely are investors looking at fund manager accounts?

We certainly see more proactive requests for the accounts with LPs asking GPs, particularly newer GPs, to share their budgets. LPs are also spending time with CFOs looking at how the manager is budgeting for business expenses.

The process continues to get more sophisticated with more scrutiny. It is harder to launch in this environment, and I do believe that's why we are seeing more and more teams lift out and set up on new platforms rather than setting up on their own. The cost of raising capital from institutional LPs has clearly gone up. ■



Alignment key as LPs seek more relationships

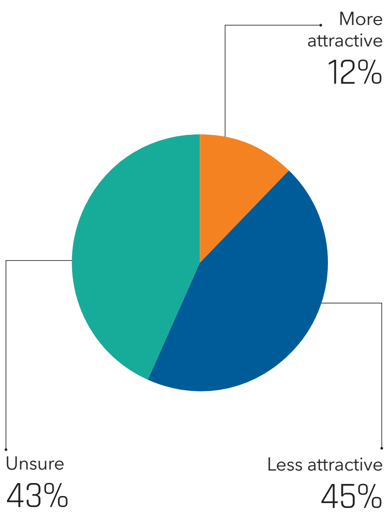
Investors seek out new managers but get tougher on diligence.
By Claire Coe Smith

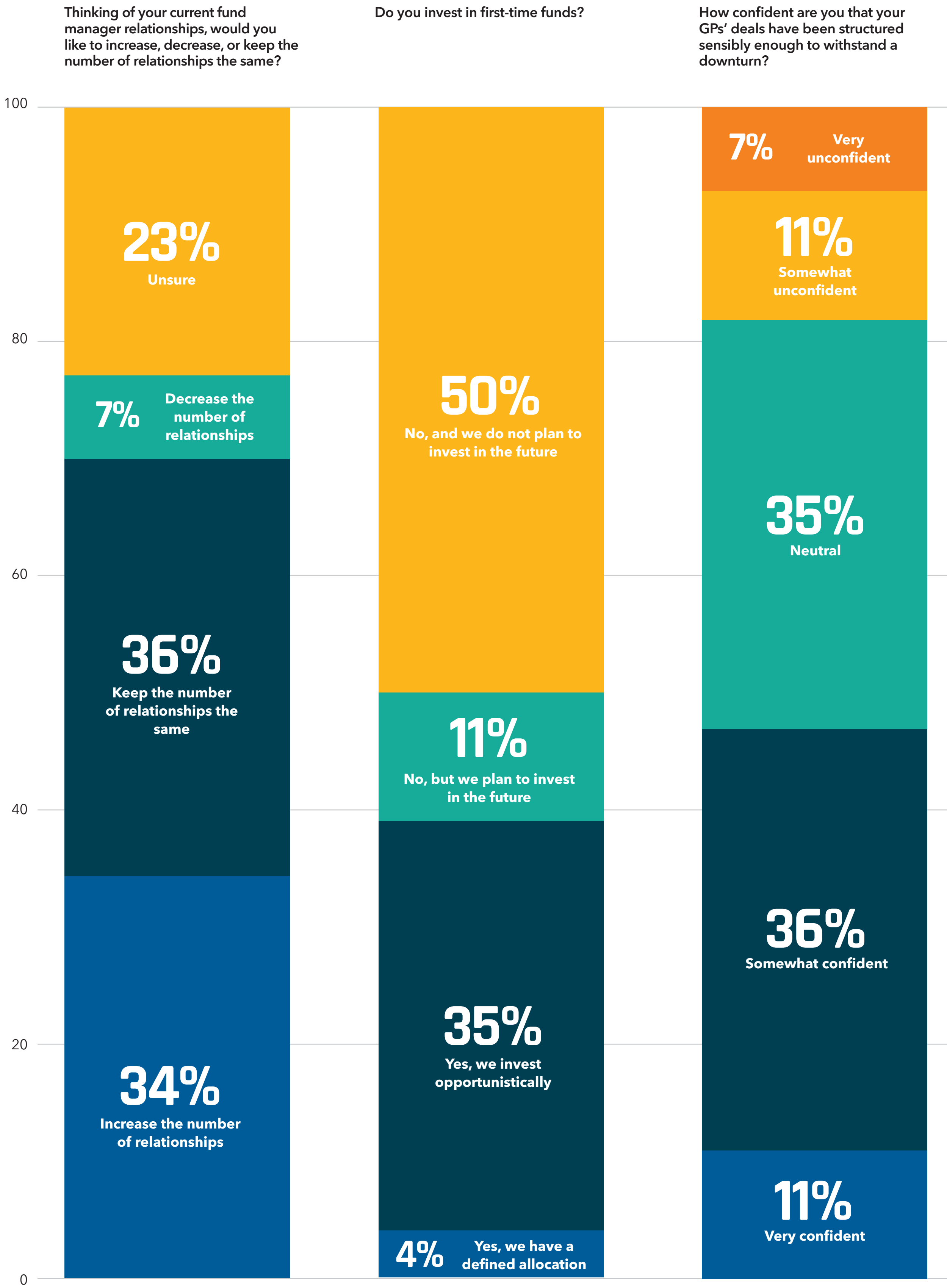
With LPs keen to address underallocation to private debt, more than a third are now keen to increase the number of fund manager relationships they have in their portfolios. In all, 70 percent of private debt investors says they would like their roster of managers to either stay the same or increase in 2020, with only 7 percent looking to decrease the number they work with.

But despite this appetite for diversifying manager relationships, the majority of private debt investors do not invest in first-time funds. In all, a total of 61 percent say they avoid first-timers, which is the highest percentage for any of the alternative asset classes. Just 11 percent of those that do not invest in first-time funds intend to do so in the future, while 4 percent have a defined allocation for debut funds and a further 35 percent are willing to opportunistically invest in new entrants. These figures contrast with those for private equity, where more than half of LPs are willing to invest in first-time funds and only 37 percent have no plans to do so.

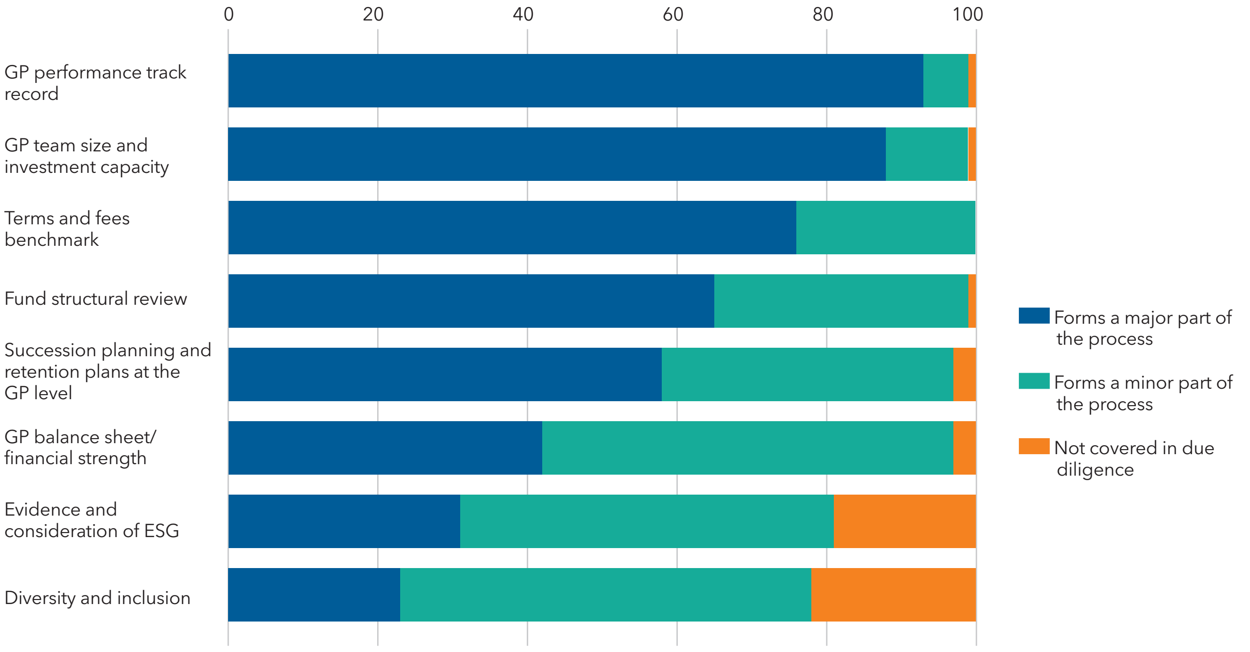
Rather, as investors seek to expand their rosters of private debt GPs, it is still the manager's performance track record that dominates an increasingly rigorous due diligence process where alignment through fund terms is often the focus. Some 93 percent of respondents describe track record as forming a major part of the diligence process, while 88 percent say that team size and investment capacity play a large role, and 76 percent point to terms and fees benchmarking as important. A majority of LPs

Does selling a stake to an outside investor make a GP a more or less attractive investment partner?




Thinking of your current fund manager relationships, would you like to increase, decrease, or keep the number of relationships the same?
Do you invest in first-time funds?
How confident are you that your GPs' deals have been structured sensibly enough to withstand a downturn?
100
80
60
40
20
0
23% Unsure
7% Decrease the number of relationships
36% Keep the number of relationships the same
34% Increase the number of relationships
50% No, and we do not plan to invest in the future
11% No, but we plan to invest in the future
35% Yes, we invest opportunistically
4% Yes, we have a defined allocation
7% Very unconfident
11% Somewhat unconfident
35% Neutral
36% Somewhat confident
11% Very confident

How significant a part do the following play in due diligence? (%)



Source for all data: Private Debt Investor

list two other criteria as being critical to due diligence: the fund structural review, and the succession plans and retention planning in place at GP level.

Diversity and inclusion, and consideration of environmental, social and governance issues were seen as much less important. Just 23 percent say diversity and inclusion play a major part in the process, while only 31 percent say the same about ESG. Some 22 percent say diversity is not covered by due diligence at all, while 19 percent say this is the case with ESG.

Tavneet Bakshi, partner and head of EMEA at FIRSTavenue, says that for the more sophisticated LPs, ESG is definitely moving up the agenda in private debt: "ESG is a hot topic at the moment. It is pleasing to see a number of GPs really taking that seriously in terms of putting in place ESG checklist procedures and thinking about ESG not just in terms of avoiding investments but also in terms of putting in ESG-specific KPIs in loan documentation.

"There are a lot of GPs who genuinely want to be ESG-friendly and compliant, but they are also getting pressure from LPs. The LP community has voiced in a very big way that this is not just a box-ticking factor in their due diligence. They will spend time on it, ask questions and look into the case studies."

"There are a lot of GPs who genuinely want to be ESG-friendly and compliant, but they are also getting pressure from LPs"

TAVNEET BAKSHI
FIRSTavenue

One of the challenges for private debt managers when it comes to ESG is finding ways to exert influence, given their position as lenders rather than owners. "Because you don't necessarily control the investment as a lender, this requires a much more nuanced approach, so it is still nascent in private debt," says Bakshi.

Another recent trend is that of fund managers selling stakes in themselves to outside investors, which has been on the increase even among some of the industry's most significant players. LPs are wary about the implications of such activities when it comes to control and alignment of interests, with 45 percent saying selling a stake makes a GP a less attractive partner, and only 12 percent believing it makes a manager more appealing.

Investors are attaching increasing importance to alignment across the spectrum – whether in relation to the GP commitment, fees on committed capital or the level of risk-sharing represented by hurdles and catch-ups. Against this backdrop, there is a feeling that third-party ownership might detract from the manager's say in strategy and control over decision-making. ■

On the minds of the top LPs

Four leading investors give their thoughts on what to expect in 2020

Our panel

"I'm restless about finding genuinely differentiated offers"

TREVOR CASTLEDINE
Senior director – private markets, bfinance

"I expect there to be some pockets of value in certain US-focused asset-backed credit products"

TODD COHEN
Director, New York Presbyterian Hospital

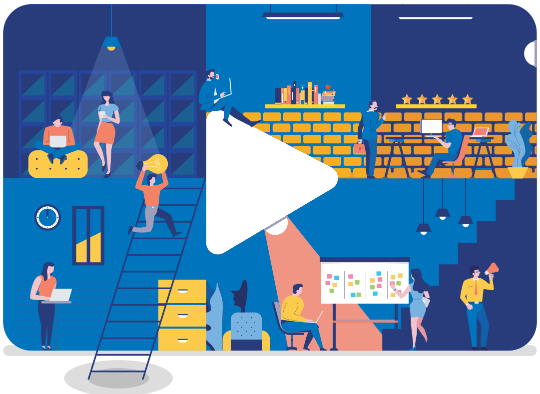
"Fundraising continues to be a challenge for many smaller managers"

RICHARD COLDWELL
Director responsible for fund investments, British Business Investments

"Don't get greedier with fund economics – ie, don't raise your management fee"

JIM GROSSMAN
CIO, Pennsylvania Public School Employees' Retirement System

What investment issues keep you awake at night?



Trevor Castledine: I am concerned about mainstream private debt keeping unviable companies alive, especially while supporting profitable exits for equity investors. There may be too much money chasing too few good deals in certain sectors of the market and new transactions being written which will be reliant on refinancing, not company cashflows, to get principal returned to investors. I'm restless about finding genuinely differentiated offers in the private debt space.

Todd Cohen: As the rally continues and future market gains surge forward, I'm concerned about what this means for the future return environment.

Richard Coldwell: I hope the learnings of past cycles are not lost and that managers maintain their standards in credit selection.

Jim Grossman: Low expected returns for the next 10 years and high valuations.

What surprised you most in 2019?

TCa: The amount of money raised for speculative 'opportunities' funds was perhaps a bit surprising. It also surprised me – although perhaps it shouldn't have – that the money raised for performing private debt strategies was so concentrated among a very small number of very similar offerings. I hope these things are not indicative of unsophisticated – or reactive, rather than proactive – decision-making among the investor community.

TCo: The strength of the bond rally and US Federal Reserve rate cuts surprised me in 2019. I expected a much more neutral environment in both.

RC: As a Sheffield United fan, I didn't think we would ever make it back to the Premier League. On a professional level, despite the various challenges in the world, I was still surprised that fundraising continues to be a challenge for many smaller managers.

JG: The performance of the US equity market.

What's the biggest challenge in 2020?

TCa: For investors, maintaining diversified global exposure with the right risk-reward characteristics will require conscientious effort. Re-upping with existing managers should be an active decision having reviewed the market, not a passive one. For managers, being tough with equity investors on problem positions is going to be challenging and may highlight a weakness in the 'sponsor-led' market if new dealflow depends on too much compromise on exiting deals.

TCo: The ability to navigate uncertainty – elevated valuations, election year, ongoing trade war – will continue to complicate investors' ability to be convinced on any market strategy asset class.

RC: For managers to maintain discipline at this stage of the cycle.

JG: The largest challenge for PSERS, with a limited private equity budget for commitments, is deciding which PE funds in the market to say "no" to. We have said "no" to some very promising funds in the market.

“Managers [should] maintain discipline at this stage of the cycle”

RICHARD COLDWELL
British Business Investments

What's your one piece of advice for fund managers?

TCa: To allocators – take the time and advice to understand the whole market and invest through the cycle where the supply and demand dynamics are in your favour. To fund managers – hold discipline. It's better to miss a deal with poor characteristics than to explain to your clients why you lost their money doing something you promised you wouldn't.

TCo: Put money to work, but don't feel pressured to do so. GPs and LPs get frustrated when capital isn't called as expected, but we should all be cautious. Patience will be rewarded.

RC: Focus on portfolio monitoring. Close management of investments, particularly those that are underperforming, is a key driver of returns.

JG: Don't get greedier with fund economics – ie, don't raise your management fee, drop your preferred return, etc.

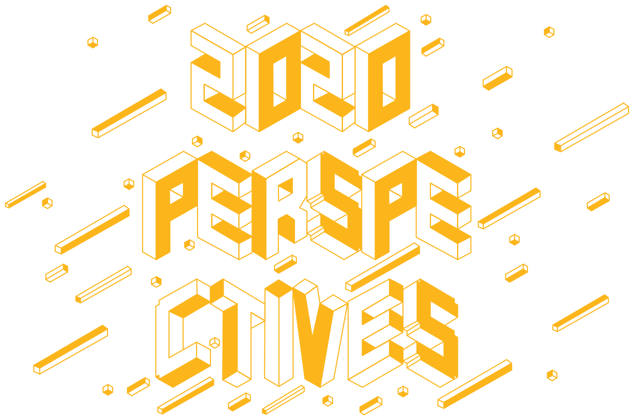
What are the most promising regions and strategies in 2020 and why?

TCa: Junior positions in carefully constructed collateralised loan obligations will generate good lifetime outcomes if some volatility can be tolerated. Lending to smaller companies or secured on real assets seems under-supplied and therefore likely to give good risk/return characteristics. I believe that the UK will deliver good returns, having been shunned to an extent due to Brexit uncertainty, and that some emerging market strategies will start to gain the traction they deserve. Having said that, I would always advocate maintaining a balanced portfolio.

TCo: I expect there to be some pockets of value in certain US-focused asset-backed credit products.

RC: I am UK-based so you might expect me to say this, but the UK is a great place to do business. With the prospects of a settlement on the Brexit issue and greater political stability, hopefully returns in 2020 will not lag other markets.

JG: PSERS has had the best recent PE performance from our US funds. I continue to believe the best opportunity for PSERS is in the US, although we have some nice opportunities to invest in Western Europe too. Being a dollar investor helps currency-wise too with our US commitments. We expect returns to be diverse, but the best performers will continue to do well.



Still too early for secondaries in credit

Some players are gearing up, but investors remain reticent to commit to private debt secondaries, writes Claire Coe Smith

Although the secondaries market continues to grow for alternative assets, investors are yet to be convinced that the time is right for secondaries to take off in private credit.

Of all the alternative asset classes, it is private debt that gets the most resounding thumbs down from LPs when they are asked about their plans to commit to secondaries funds in the next 12 months. In this year's *LP Perspectives Survey*, 60 percent of investors say they have no intention of going into private debt secondaries, with a further 28 percent unsure and only one in 10 likely to do so.

The number planning to commit is lower for private debt than it is for secondaries funds in the other alternative asset classes of private equity, private real estate and infrastructure. What's more, when asked whether they plan to buy or sell stakes on the secondaries market during 2020, only 5 percent say they will be buying and selling and just 7 percent say they are interested in buying in private credit. In all, 53 percent say they will not be buying or selling; again, this was the highest disapproval rating of any of the asset classes.

Verdun Perry, global head of strategic partners in Blackstone's secondaries unit, told sister publication *Secondaries Investor* in December that the scale and maturity of the private credit market means now is not the right time for secondaries to take off. He said: "If you look at the size of the credit market and the ageing of that strategy, it's not quite ripe for secondaries yet – certainly not for a dedicated programme of size.

"The question that I ask myself is: will there be a time and, if so, when will it be right for a dedicated secondaries programme focused on credit funds? We'll see. It's unclear, but today it's not the time. It's still relatively small."

In private equity, the LP-led secondaries process has become pretty standard, and GP-led opportunities are now also taking off. There are many sophisticated players gearing up for the same to happen in debt.

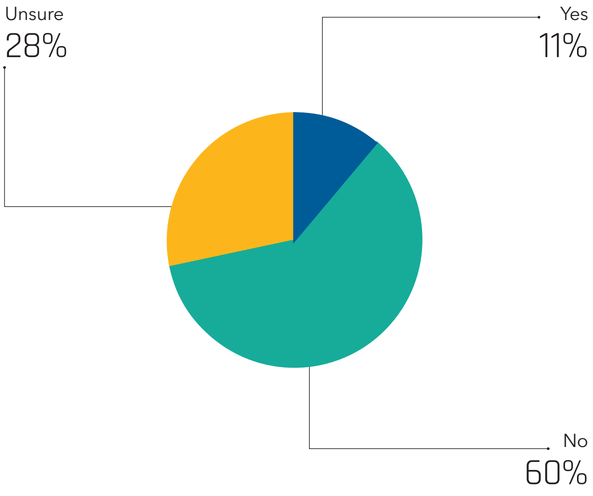
In December, Pantheon appointed a new global head of private debt in preparation for a push into providing liquidity solutions across private debt, having begun speaking to investors last year about a dedicated secondaries debt fund. In March last year, the firm led the $400 million restructuring of Avenue Capital Group's 2011-vintage credit vehicle Europe Special Situations Fund II.

Similarly, Paris-listed alternatives manager Tikehau Capital in November hired

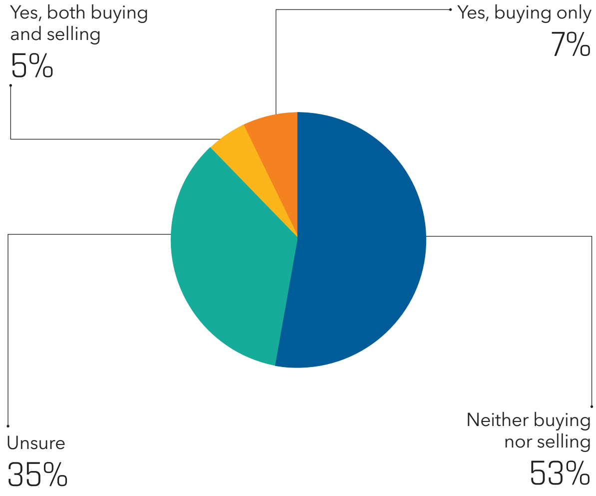
60%

of investors have no intention of going into debt secondaries

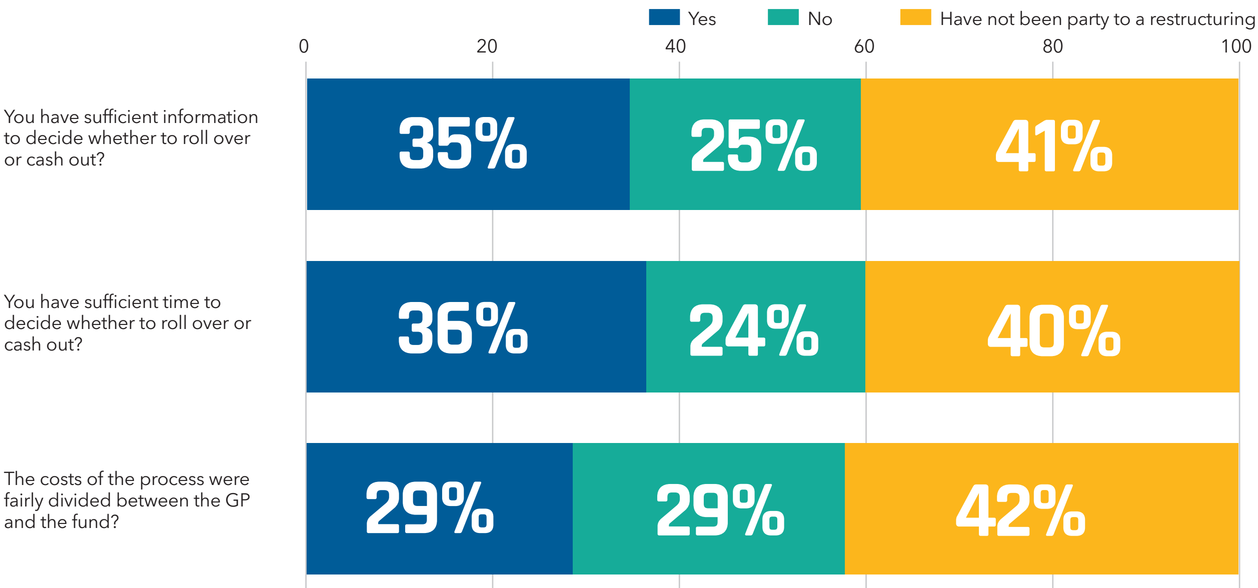
Do you plan to commit to private debt secondaries funds over the next 12 months?



Do you plan to buy or sell fund stakes on the secondaries market in the next 12 months?



GPs are increasingly instigating restructuring processes on old funds to move assets into a new vehicle. In these circumstances, do you believe:



Source for all data: Private Debt Investor

Figures may not add up to 100% due to rounding

a new head to launch its debt secondaries business.

But the market remains divided between those who think the levels of volume and the attractiveness of the opportunities in private credit secondaries mean it is about to take off, and others who feel it is still too early.

The flurry of GP-led restructurings that has taken place in the past couple of years has also caused mixed sentiment among investors. Where restructuring processes have been instigated by GPs on old funds, to move assets into a new vehicle, LPs are divided on whether they feel they were given enough time and information to decide whether to roll over or cash out.

Investors that had been party to a restructuring were split precisely down the middle on the question of whether the costs of the process had been fairly divided between the GP and the fund, with only a slight majority feeling they had been given the time they needed to make decisions during the process.

Nevertheless, many LPs still believe it is just a matter of time before debt secondaries take off in a big way. Jeff Hammer and Paul Sanabria, now global co-heads of Manulife's secondaries business, said in August last year: "The private credit secondaries market is enormous, arguably bigger than the $75 billion private equity secondaries market." ■

EXPERT Q&A

As strategies proliferate and limited partners scale their investments, expectations of customer service are ever increasing, says Paul Burdell, CEO of LCM Partners

Managing growing LP demands as the industry matures

Whether it is increased reporting requirements or requests for separately managed accounts, investors are placing far greater demands on fund managers these days. *Private Debt Investor* sat down with Paul Burdell, CEO of LCM Partners, to discuss the challenges GPs face when trying to meet these LP demands as they also continue to grow their own businesses.

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Q What are the client service trends you are experiencing?

First and foremost, we are in a client service business. Although we are all trying to generate best-in-class returns, it is equally important to ensure we provide LPs with the highest level of customer service. With that in mind, as the industry has evolved so have we.

Something that we are certainly seeing more of is increased demand for separately managed accounts (SMAs). This has come from some of our larger LPs who have expressed a preference for their own account for security reasons or to allow some form of customisation to their investment mandate. We wanted to have the ability to accommodate these demands so made sure that, operationally, our platform can manage SMAs alongside our commingled vehicles.

From a client service perspective, the biggest development has been around client reporting. In addition to our standard reporting, we now receive a significant number of other reporting requests that can be broadly split into three categories.

The first relates to growing regulatory requirements. A good example is around European insurance LPs. Since January 2016 when Solvency II came into effect, we have had to provide data on our underlying portfolio investments in a Solvency II friendly template. Then, last year we received a whole raft of requests to help these insurance LPs demonstrate to their regulators, who are increasingly scrutinising their illiquid investments, that they are managing their commitments in compliance with the Prudent Person Principle.

The second category of requests is related to environmental, social and governance standards. ESG has always been a part of typical LP reporting and due diligence, but the majority of our LPs now ask that we complete a standalone ESG questionnaire on an annual basis. We are encouraged to see ESG considerations becoming more mainstream and expect this trend to continue both for LPs and GPs. Indeed, the EU Disclosure Regulation, which entered into force on 29 December last year, confirmed that European financial firms will be required to disclose how they integrate sustainability considerations into their processes in a standardised way from 10 March 2021.

A final development that we have seen has been LPs' increased use of third-party data exchanges either via online platforms or consultants. Although many investors have scaled their private debt commitments materially in recent years, their teams remain lean. As a result, using some form of third-party data aggregator to collect GP data in a standardised format makes a lot of sense.

Q What has your experience been with the data exchanges?

In general, they have been good. I mentioned having to provide our underlying portfolio data in a Solvency II friendly template for our European insurance clients. In this instance, we upload one template to a data exchange and it generates the required information and reports for all our LPs who subscribe to the exchange. It's a very efficient way of ensuring we help our clients meet their regulatory requirements.

In terms of reporting and data aggregation, many of the data exchange providers have developed sophisticated reporting templates. Typically, the templates have inbuilt checks that flag data inconsistencies, advanced performance analysis and attribution, and the ability to aggregate GP exposures and performance data at the click of a button. The benefits to LPs are significant.

If we have one concern, it is the extent to which the data provided to these exchanges could be relied upon to make comparisons between managers, not only because the asset class has become much more diverse, but also because even comparisons of similar strategies remain difficult.

As a start, a high degree of sophistication is needed for these exchanges to account for factors such as the use of subscription lines, asset level leverage and the impact of foreign exchange hedging programmes. Even then, managers are reporting under different accounting standards and in line with their own valuation policies, which can vary materially.

"From a client service perspective the biggest development has been around client reporting"

Q What challenges does this additional reporting present to GPs?

Greater LP demands increase the workload for the GP investor relations teams, and other support functions, that need to be appropriately resourced. Equally important is continuing to invest in technology and streamline internal processes. That's not easy to do but something we challenge our staff to focus on. What makes it difficult, and is to a large extent out of our control, is when our LPs decide to select different exchange providers so you end up performing the same exercise five times but in a slightly different format for each provider.

The other main challenge is that when an LP uses a data exchange or a consultant to aggregate GP data, to a certain degree the GP loses control of how that data is being presented to the LP. This often leads to questions from LPs. It's in this area where we really see the value-add of consultant data aggregation offerings over online data exchanges. The consultants have a deeper understanding of GP investment strategies and so are better placed to clarify any inconsistencies.

Moreover, we've been really impressed by the extent to which the consultants maintain a continuous dialogue with GPs to ensure that the data templates are being populated correctly. Looking ahead, it's undoubtably a smart move on their part though. These consultants are building fantastic data sets on the leading GPs globally, which can only serve to improve their holistic offering to LPs going forward.

Q Do you think GP reporting standards are improving?

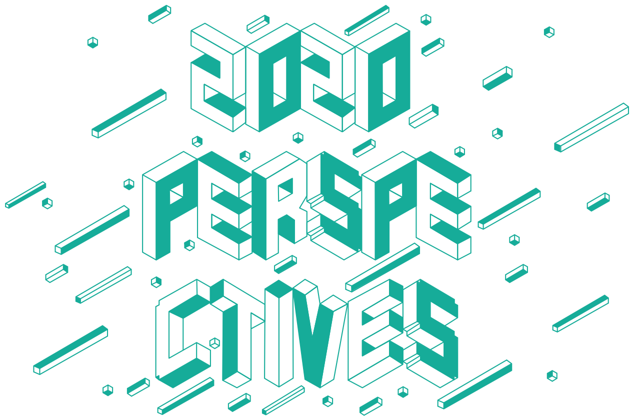
Undoubtedly yes – it's a competitive fundraising environment and there is now a wider appreciation in the industry that a first-class client service offering is a 'must-have' rather than a 'nice-to-have'. Having said that, in many cases we think managers are starting from a low base and that levels of transparency in particular can still be improved.

We have to be conscious that with our investment strategy in private credit, LPs do not generally have the benefit of either first-hand experience or alternative information sources. There are no observable public comparables for the acquisition of portfolios of consumer or SME loans and the investments tend to be relatively bespoke and granular in nature.

We cannot expect our investors to know the intricacies of particular servicing strategies, cashflow profiles and cost arrangements in a diverse pool spanning hundreds of thousands of credits over 10 European markets. It is our job to provide the level of detail which they need to ensure they fully understand the performance and risk profile of their investment with us.

In short, we're providing complete transparency on a portfolio-by-portfolio basis. This kind of challenge is not that unusual across the private markets industry and yet in some instances we are surprised by the extent to which it is not being fully addressed by managers.

Nonetheless, the industry is certainly moving in the right direction and it's an area where we recognise the need to be a market leader. ■



Co-investments continue to be hot

Institutional investors are changing policy and hiring more internal talent to increase their co-investments, writes Preeti Singh

Co-investments have become a preferred method for investors to reduce management fees and maximise returns, but LPs also benefit from developing closer relationships with their GPs and flexing their diligence chops. Not surprising then that investors across private market strategies are aiming for more co-investments.

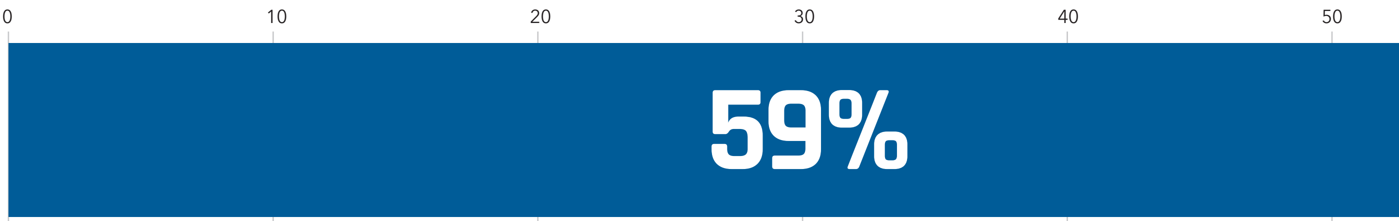
Nearly 59 percent of LPs plan to invest in co-investment opportunities, according to the *LP Perspectives Survey 2020*. While only 26 percent of private debt investors plan to participate in co-investment opportunities in 2020, more private debt investors are interested in co-investment than last year.

Bullish market

Investors have reason to be bullish on co-investments. Alaska Permanent Fund Corporation is one of the few LPs to publish its co-investment returns; most investors blend them into total private equity returns. APFC's co-investment programme was delivering a five-year annualised net return of 61.5 percent, according to its latest annual report for the fiscal year ended 30 June 2019. But across the board, LPs affirmed their co-investments had performed well. "Our co-investments have absolutely outperformed our regular funds. The deals we have been seeing have outperformed the funds themselves," Tamara Polewik, director, principal investments, private equity, Teacher Retirement System of Texas, said last year.

Arizona Public Safety Personnel Retirement System's co-investments generated a net internal rate of return of 12.2 percent and a total multiple of 1.53x since inception in 2006, as of 31 March 2019. Over the same period, the net IRR and net multiple of the

Do you plan to participate in co-investment opportunities in private equity over the next 12 months?



private markets portfolio was 9.95 percent and 1.3x, respectively, documents show.

There is plenty of activity afoot at both big and small pension systems. Some, such as New York City Public Pension Funds, are building brand new co-investment programmes. Others, like California Public Employees' Retirement System, which suspended its co-investment programme in 2016, are refocusing their attention on the strategy, while California State Teachers' Retirement System, Arizona PSPRS and Pennsylvania Public School Employees' Retirement System are expanding their co-investment programmes.

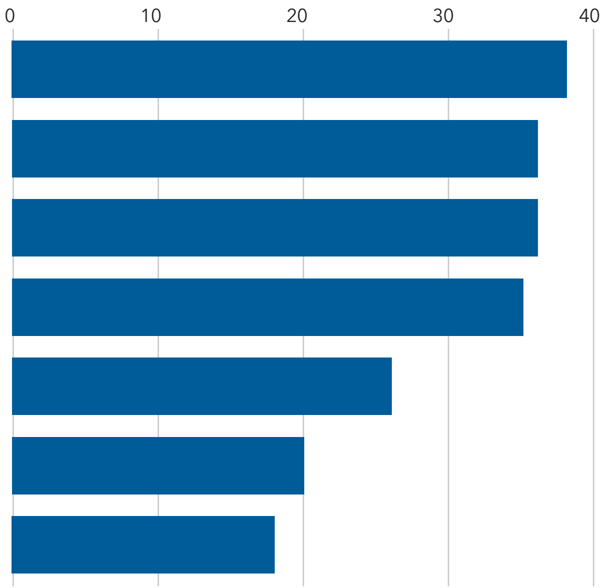
Change to suit

Investors have made policy changes to become nimble and responsive to co-investment opportunities that often come with small windows for investing. For instance, speed is a critical issue in making co-investments: CalPERS' new policy states that for investments below $100 million, staff do not need a prudent person opinion and discretion rests with the managing investment director; for co-investments up to $200 million, staff need chief investment officer approval or a prudent person approval.

Meanwhile, CalSTRS made lots of changes to its co-investment policy in 2018. It can now make co-investments with managers across strategies instead of being limited to its private equity GPs. Importantly, CalSTRS can engage alongside general partners earlier in the investment process and commit to transactions with break-up fees. CalSTRS also increased the limits in the sizes of commitments made under delegation of authority to up to $250 million and hired AlpInvest Partners to reach the smaller end of the private equity spectrum.

Similarly, South Carolina Retirement System Investment Commission teamed up with an external manager, Chicago-based asset manager GCM Grosvenor, in July to ramp up its co-investment activities.

Speed of transaction and not being staffed up for the opportunity are the most likely to hinder co-investment participation (%)



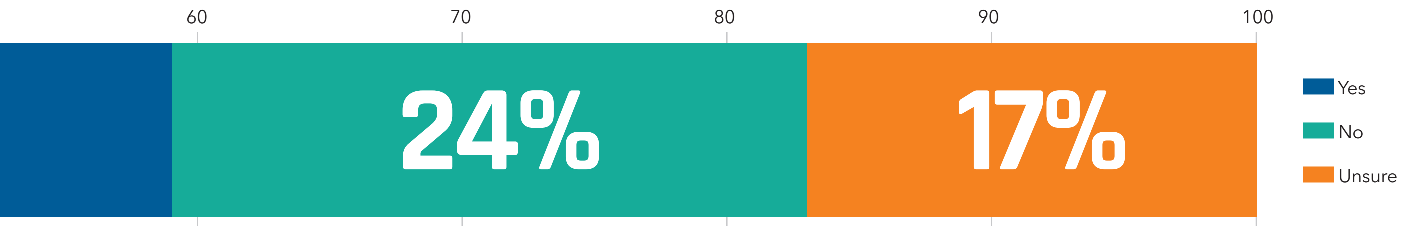
Source for all data: Private Debt Investor

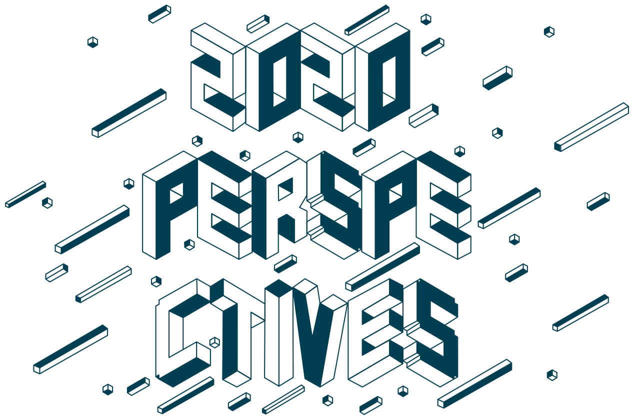
Teacher Retirement System of Texas's co-investing programme, which started in 2009, accounts for between 20 percent and 25 percent of the portfolio; the allocation is set to increase to 35 percent of the portfolio, according to Neil Randall, managing director, private equity. Likewise, Arizona PSPRS, which began its co-investment programme in 2008, is expanding its co-investment programme from 10 percent of its private markets portfolio to 20 percent. "We are scaling up our programme so that it becomes big enough to move the needle," says chief investment officer Mark Steed.

Investors are also expanding internal resources and enhancing skill sets to deal with co-investments. For instance, Texas TRS is doubling its team in the next three to five years to 30 investment professionals. The majority would be supporting co-investment work, Randall says.

CalSTRS and CalPERS plan to hire more people for co-investments. CalSTRS has eight senior staffers for private equity, and four of them are trained in co-investing, according to director of private equity Margot Wirth at the 30 January 2019 meeting. "We are not novices at co-investing and we are not new to the game by any means, but relative to our size we are leaving a lot on the table," Wirth said. "If we want to go from 10 percent to 20 percent co-invest, we would need to cross-train our team … it's basically extending what we already have, scaling up."

Transaction speed and staff capacity, followed by risk level and ticket sizes, are the main factors that deter LPs from participating in co-investing opportunities. Still, LPs are not daunted by lack of opportunity to be invited to participate, which is the least likely to hinder participation. As supply and demand continue their upward movement, investors will gravitate towards opportunities that provide them with the ability to diversify, hedge against risk, and enable outperformance, according to the survey. ■





The more things change…

Industry players say fee transparency has been increasing. So why are more LPs asking for more of it? Graham Bippart reports

Something is eating at investors' patience with their GPs. Management fees appear to be in line with, or better than, the historical average of 2 percent. Management fee offsets against other fees can range up to 100 percent. And transparency and disclosure of various fees have generally increased in recent years.

Yet 73 percent of LPs in this year's survey say the fees charged by private equity funds are difficult to justify internally – up from 63 percent last year. And management fees once again top the list of fund terms that cause the most disagreement with GPs when conducting due diligence.

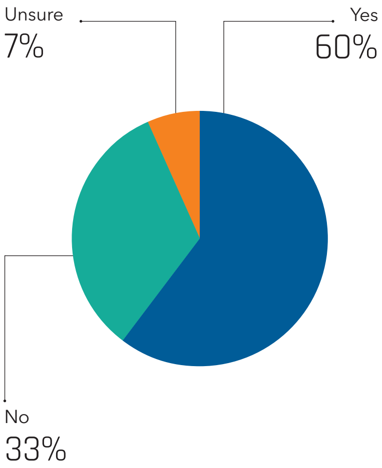
> *"I'm sceptical about the industry adopting [the ILPA model LPA] on a large scale"*
>
> **CHRISTIAN KALLEN**
> **Hamilton Lane**

So what's going on? In part, industry players say investors continue to get miffed about fund sizes growing, resulting in ever-increasing management fees in absolute terms coming out of private equity funds. And as limited partnership agreements become longer and more complex, some LPs may be getting exasperated trying to find out exactly what's what. That may illustrate why, even though many industry players say transparency and disclosure have improved, 60 percent of LPs – down from 65 percent last year – have asked their GPs for more of it in the last 12 months.

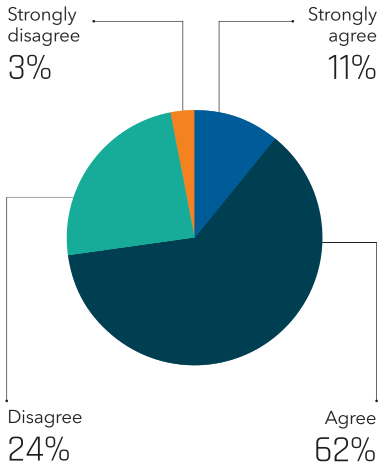
Clearer but more complex

There's more transparency, but more complexity too. "LPAs are often written in code," says Eamon Devlin, partner at MJ Hudson, who believes LPs are constantly just trying to catch up with changing fee definitions. While two LPAs may charge the same rate on the same nominal service, the definitions of those services often differ from LPA to

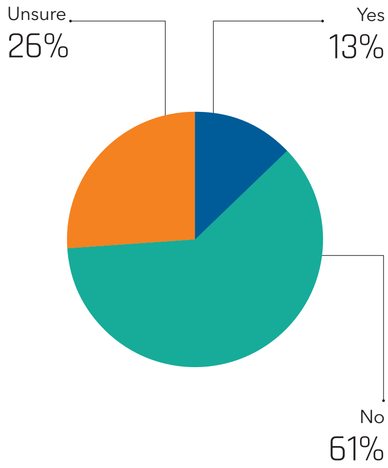
Have you asked for greater fee transparency and disclosure from your GPs in the last 12 months?



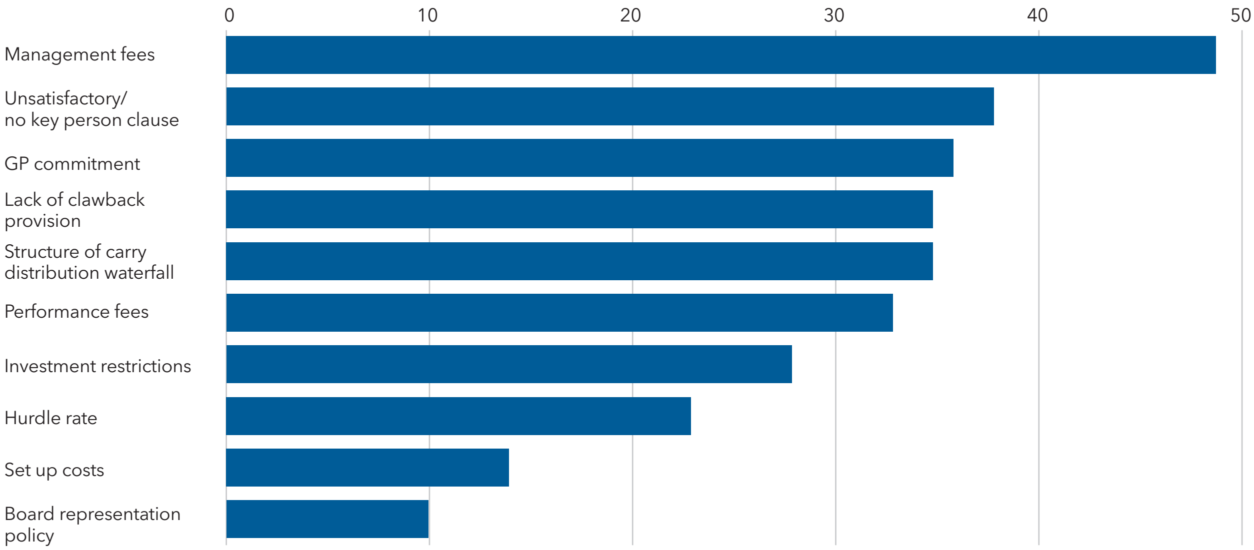
To what extent do you agree that fees charged by private equity funds are difficult to justify internally?



Over the next 12 months are you planning to seek external help when it comes to fee validation?



Which three LPA terms cause the most disagreement with GPs when conducting funding due diligence? (%)



Source for all data: Private Debt Investor

LPA, making it difficult to quantify exactly what is being paid for out of the funds.

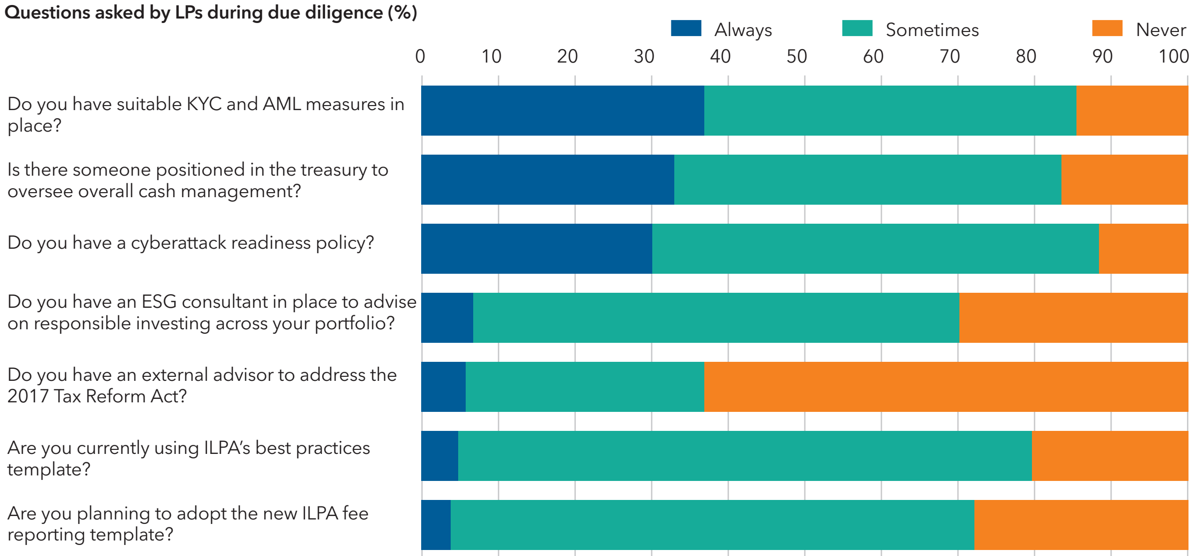
And LPs are more aware of just how much money is being made from their investments. The trend in recent partial management committee sales illustrates how profitable they are, Devlin says. But it isn't just uncapped management fees that are galling investors; it's also the revenue GPs are making off related business. "That's definitely a sore point," says Tim Selby, partner at Alston & Bird, speaking about GPs generating commissions off portfolio companies, which may not flow back into the fund. "The investment manager is using their investment dollars to get outside business opportunities … those should offset management fees."

All this may go towards explaining why, even if LPs want more transparency on fees, 61 percent are still unlikely to seek external help for fee validation. True, it is a new phenomenon, and many market players still do not even know what such a service might entail – though the California State Teachers' Retirement System did exactly that, seeking to better understand whether the fees it pays

The CFO view: What LPs really want

Our latest CFO survey reports a rise in due diligence requests from LPs as fund sizes grow

Questions asked by LPs during due diligence (%)



Source: Private Funds CFO Insights Survey 2019

Last year was another bumper one for fundraising – and that meant dealing with more investors. At the same time, those investors are seeking more information and demanding greater detail from GPs, suggests sister title *Private Funds CFO*'s *Insights Survey 2019*.

For the annual survey, *Private Funds CFO* polled 124 US fund CFOs in July and August 2019. Two-thirds of respondents – dominated by mid-market firms with vehicles in the $100 million-$500 million bracket – expect their next vehicle to be larger than their current fund.

More transparency is increasingly important to LPs, according to survey respondents. LPs are "generally asking for more transparency into fund information", said one CFO. Another elaborated that LPs also want transparency into "track record, reporting quality and safety of electronic data".

On due diligence, roughly a third of respondents report that investors always ask about know your customer and anti-money laundering policies, cash management oversight and readiness for a cyberattack. Demonstrating good governance is key.

But performance and track record data remain, unsurprisingly, the core requirements for LPs. Paramount to LPs are, "one, consistency of returns; two, consistency of team, including next generation succession; and three, consistency of strategy and how you execute against that strategy, ie, – LPs do not like to see strategy stray", one respondent said.

During due diligence, LPs like to interact with the CFO in person. The proportion that always demands to meet the CFO is rising (16 percent), while a solid majority (72 percent) sometimes requests this. "Operational due diligence has increased greatly over the past few years too," said one chief compliance officer.

are in line with the LPA terms. But also, investors do not just want more transparency about what is taking place in the fund; they want to know what is happening outside of it too.

"These are all truly related-party transactions, whether it's within the fund or outside of the fund," says Jeffrey Rosenthal, partner at accounting firm Anchin, Block and Anchin. That's leading to greater scrutiny of all a GP's revenues by regulators, auditors and investors alike.

After management fees, at 49 percent of respondents, LPs said the terms that caused the most disagreement with GPs were unsatisfactory/no key person clauses (38 percent), the GP commitment (36 percent), lack of clawback provision (35 percent) and structure of carry distribution waterfall (35 percent) – all fairly consistent with last year's poll.

Levelling the field

To an extent, the level of improvement in various fund terms may depend on an LP's industry weight. And since LPs do not know who else is in the fund, it is near impossible to tell whether they are getting good terms relative to their peers. To that end, in October the Institutional Limited Partners Association introduced a model LPA that could help level the playing field and make fund terms more consistent.

Unfortunately for LPs, the model LPA is not getting a lot of traction with private equity funds and their lawyers, although it is still early days. Christian Kallen, managing director in the fund investment team at Hamilton Lane, says the model LPA would be great for the whole industry. But, he adds: "I'm sceptical about the industry adopting it on a large scale." ■

E X P E R T Q & A

From rigour in due diligence to a more hands-on approach to governance, debt managers can play a crucial part in responsible investing, says Jean-Marc Fiamma, partner at CAPZA

Lenders have key role in driving ESG

Q What requests and expectations are you currently seeing from LPs on the subject of ESG?

We have noticed that LPs are more and more concerned about environmental, social and governance issues. This can be observed during the fundraising process when a growing number of ESG questions are now routinely included in the due diligence questionnaires. The most sophisticated LPs even have dedicated questionnaires on ESG.

We feel that ESG is becoming a global concern, but we still see variations between investors in different jurisdictions. Perhaps unsurprisingly, investors in the Nordics are generally the most concerned, but French investors are also very keen on ESG.

LPs are enquiring about ESG both at the portfolio and the management company level, with increasingly sophisticated questions such as the integration of climate impact. There are also more requests from investors to have specific ESG requirements reflected in side letters or by-laws, whether these are enhanced exclusion rules or increased reporting requirements.

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Q What role can private debt managers play in driving ESG commitments across a portfolio, given the role is only that of lender?

Debt managers can't drive their portfolio's ESG impact in the same way as private equity sponsors, but we still believe we have an important role to play and so do LPs. We have no formal right to impose our views or requirements, but there are two crucial ways we can influence ESG.

First, before the investment process, we perform increasingly in-depth ESG due diligence. We can decline an investment if we don't consider it to be fully ESG-compliant. Second, during the life of the investment, we perform an annual ESG review with detailed criteria and we work hard to share our views with both the management and the private equity sponsor.

When we are working with a sponsor on a transaction, we try to assess its maturity on ESG topics and, if we deem it is not enough, we try to drive change. As we often have observer seats on the boards of directors of the companies that we lend to, we try as much as we can to raise ESG matters to the agenda of the board throughout the life of our involvement. In the context of sponsored transactions, more and more PE sponsors are now performing ESG annual reviews that we integrate into our own monitoring tools. If we think the report is incomplete, we will request that additional performance indicators are monitored.

We also do sponsorless transactions and there, of course, we can be more influential because we are in a one-to-one relationship with the management team. Again, while we don't have any formal right to direct because we are not a shareholder, in most cases we do get the opportunity for input.

Q How do you measure and track ESG progress across the portfolio?

We perform an annual review of all our portfolios whether private debt or private equity. Our detailed ESG review seeks to monitor 15 criteria around environmental, social and governance factors. It comprises more than 110 questions.

Our objective is to have the same quality of information whether we are in private equity or private debt. We know that, in most cases, in sponsored transactions we have to work alongside the PE sponsor in order to get ESG information.

Then, we aggregate those criteria for all CAPZA's portfolios in order to build a synthetic view. This enables us to better identify what areas to place emphasis on. In 2020, for instance, we have set objectives on three criteria: increase the number of independent members on the boards of directors, formalise codes of ethics and establish formal commitment for diversity.

Q How important is ESG to CAPZA at the management company level, and what kind of initiatives are you focused on in that context?

If we want to make an impact with our portfolio companies and challenge them on ESG topics, it is pretty obvious that we have to apply the same principles to CAPZA. Until 2019, we had a number of different initiatives going on but they were not really coordinated at the company level.

We decided last year to gather all those activities into an overall approach, which we called CAPZA for Good. The first thing we did was to perform the same type of ESG analysis on our own company as we do on our investments, and identify the areas that we need to focus on. We wrote our own corporate social responsibility charter and we have already identified several areas that we intend to prioritise, including happiness at work, diversity, carbon footprint and waste management.

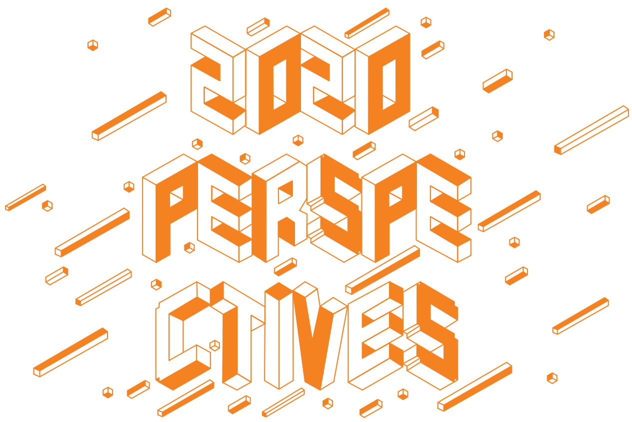
In all of these areas we now have a number of initiatives up and running – we are planning to compensate our carbon footprint by offsetting all our travel by plane, for example, and we are looking at moving from an ad hoc approach to taxi use in favour of a commitment to using green cabs. On diversity, we are now monitoring the number of women in the investment team and monitoring our progress on several different metrics in that area to make sure we continue to take diversity seriously across our business. ■

Jean-Marc Fiamma is a partner at CAPZA with responsibility for ESG issues for private debt. He is a member of the firm's CSR committee, CAPZA for Good

Q Have you ever declined an investment opportunity because of ESG concerns? If so, can you give examples?

Of course, it happened several times in the past. We recently declined an investment in a company engaged in medical tests on live animals. Another example is a company specialised in the sale of dry fruits, where we found out that some of the fruits were originated from water-stressed areas, and then transported to India for processing. We walked away from that opportunity.

"Debt managers can't impact their portfolio's ESG impact in the same way as private equity sponsors, but we still believe we have an important role to play and so do LPs"



ESG and diversity yet to take centre stage

Few LPs are prioritising sustainability, and a lack of gender balance in GPs is rarely a deal-breaker, writes Ben Payton

ESG and diversity are rarely out of the headlines these days. It feels like almost every fund manager boasts of ESG considerations being part of the firm's DNA. But our *LP Perspectives Survey 2020* reveals that a minority of institutional investors consider ESG and diversity central concerns when deciding on investment opportunities.

Just 31 percent of LPs say evidence and consideration of ESG form a major part of their due diligence process – a figure that has decreased from 39 percent last year. Half of respondents say ESG formed only a minor part of the process, while 19 percent claim they do not consider ESG at all.

Part of the problem may be that there is no standard way to measure ESG outcomes across the industry. In the absence of a clear framework to benchmark fund managers' performance, LPs lack an obvious starting point for integrating ESG into due diligence – beyond undertaking 'tick box' exercises. Speaking on a panel at the Spanish private equity and venture capital association ASCRI's Forum in London in October, Maria Sanz Garcia, managing partner of Yielco Investments, commented that "the quantitative side of this is very thin", and that the way forward is for funds to have measurable goals on specific ESG measures, such as energy usage.

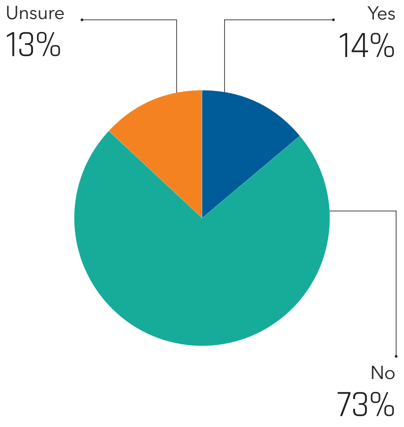
Meanwhile, the traditional interpretation of fiduciary duty favoured by regulators in the US can deter LPs from prioritising any factor other than financial return. Vadim Avdeychik of the law firm Paul Hastings told sister publication *Private Equity International* in November that "there is very little specific regulation whatsoever" on ESG in the US, but guidelines for public pensions plans mandate them to focus on maximising shareholder returns rather than addressing ESG goals. But, says Avdeychik, "what we have seen in Europe is almost the complete opposite", with an increasing volume of regulatory proposals that would require both investors and managers to undertake greater reporting on ESG measures.

Diversity dilemmas

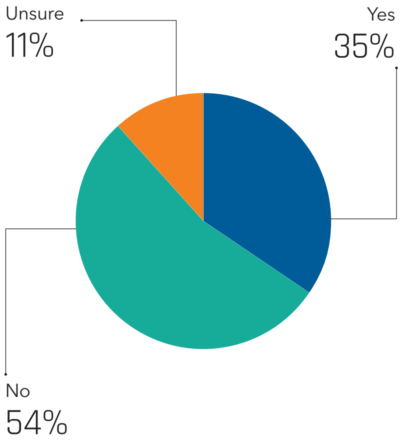
Responses on diversity are similar; it forms a major part of due diligence for only 23 percent of LPs. And for every LP placing diversity at the heart of due diligence, there is another not covering it at all. For 55 percent, it is a minor factor.

Nevertheless, 35 percent of LPs say they are actively encouraging fund managers to promote gender diversity and some, albeit still a minority, are prepared to walk away from GPs that do not reflect their values – 14 percent of respondents report that they have refused an opportunity due to a lack of diversity at the fund manager level.

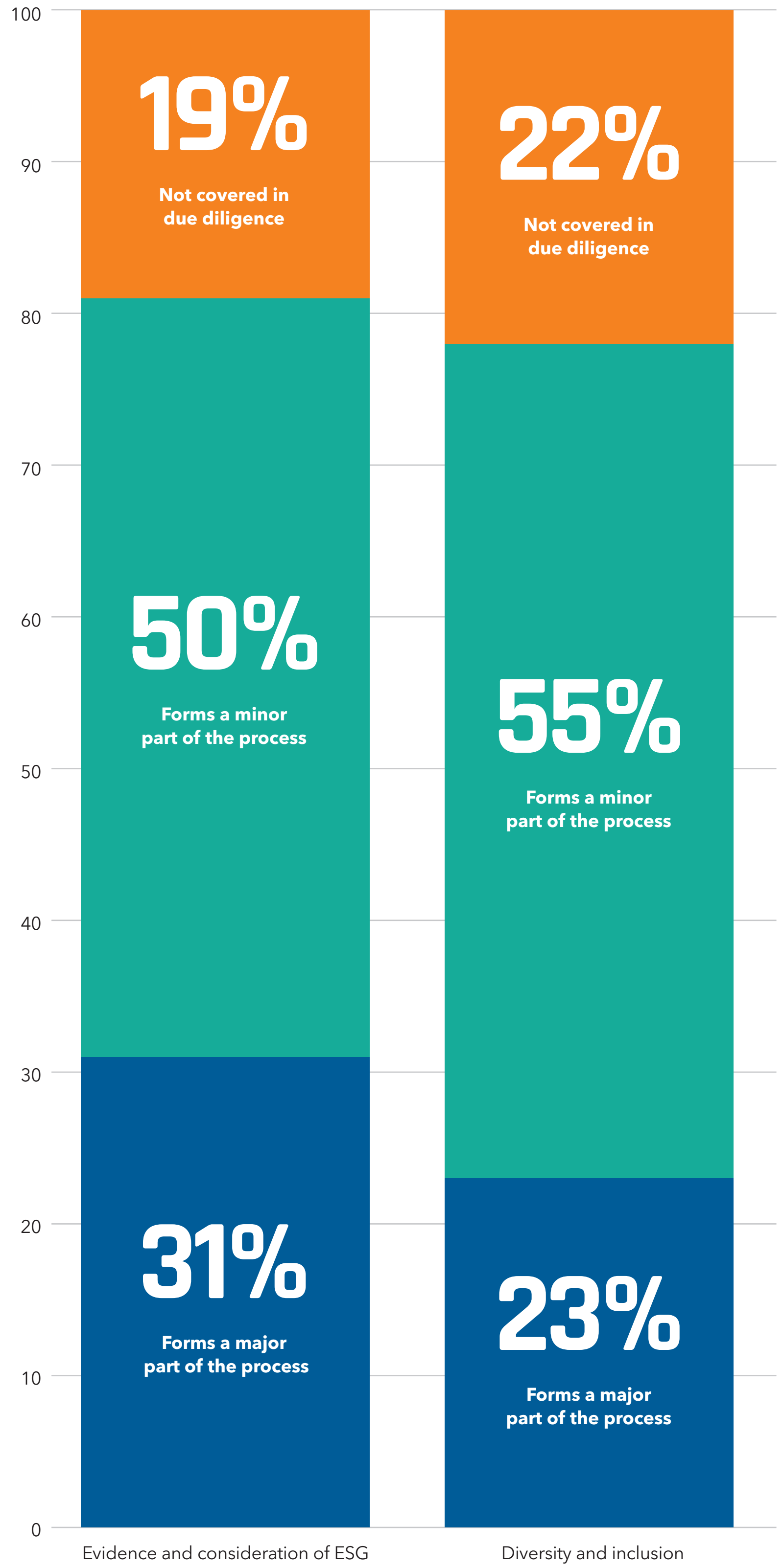
Has your institution ever refused an opportunity based on a lack of diversity and inclusion at the fund manager level?



Do you actively engage your fund managers to promote gender diversity and inclusion?



ESG and diversity are typically secondary factors in due diligence



Source for all data: Private Debt Investor

At *PEI*'s Women in Private Equity Forum in November, delegates largely agreed that LPs will ask questions about diversity but are generally reluctant to pull the trigger on withholding an investment based on diversity factors. Brunel Pension Partnership, for example, considers diversity when grading managers on sustainability. However, Gillian de Candole, an investment principal at the pension, told the forum that although a lack of diversity can leave a manager with a lower overall score, alone it would not stop a commitment.

Anamica Broetz, head of business development and strategy at DWS Private Equity, says LPs are not doing enough to use their influence to push investment teams to become more inclusive: "The pain point is at capital. If LPs start to say 'no' to teams that are not diverse enough, I think we're going to start to see a lot of change very quickly." ■

LP points of view on 2019

"I tell everyone here, 'You can't name the lobsters, because if you name them you can't cook the lobsters.' We are maniacal about not having these biases about managers"

Mark Steed, CIO at the Public Safety Personnel Retirement System of the State of Arizona, says investors should not be getting too close to GPs

"I can't stress strongly enough that we are long-term investors. We make decisions based on an investment horizon that stretches across years and even decades"

Ben Meng, CIO at CalPERS, stresses the importance of taking a long-term view of investing

"I think there will be a time when the industry realises diversity is a competitive advantage, and we're going to see that become commonplace. It may take a while, but I think it's a business issue"

David Enriquez of New York City Retirement Systems believes diversity leads to better decision making

"We've been doing a lot of research work over the past year trying to understand which markets are accessible"

John Graham, global head of credit investments at Canada Pension Plan Investment Board, on its expansion plans

"In the case of the US, it is hard to meet our target returns by investing in private real estate debt at this moment, after converting the returns into South Korean won"

Janghwan Lee of Lotte Non-Life Insurance Company on the importance of exchange rates to Korean investors

"Sometimes investors take a big brush and paint a whole sector as hazardous when there are segments within it that provide very attractive risk-adjusted returns"

White Oak Global Advisors chief executive and co-founder **Andre Hakkak** on why investors should remain open-minded